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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1934

No. 51

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

UNION PACIFIC RAILROAD COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

FILED OCTOBER 8, 1934

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1934

No. 51

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

UNION PACIFIC RAILROAD COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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Docket Entries, No. 35,639.

1

UNION PACIFIC RAILROAD COMPANY, Petitioner, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 35639.

APPEARANCES:

For Petitioner: HENRY W. CLARK, ESQ., HARRY J. GERRITY, ESQ.

2

For Respondent: E. C. ALGIRE, ESQ.

1928

Feb. 25—Petition received and filed. Taxpayer notified. (Fee paid.) (See Docket 35627.)

" 27—Copy of petition served on General Counsel.

Apr. 27—Answer filed by General Counsel.

" 30—Copy of answer served on taxpayer—General Calendar.

3

1931

Mar. 16—Hearing set May 6, 1931.

Apr. 6—Motion for continuance to Oct. 21, 1931, filed by taxpayer. April 8, 1931, granted.

" 6—Notice of appearance of Harry J. Gerrity as attorney for the taxpayer filed.

June 9—Motion to consolidate with dockets 35640 to 35649, and 35685, 35684, 40002 and 40060 to 40062 filed by taxpayer. June 11, 1931, granted.

July 24—Motion for leave to file amended petition filed by taxpayer—amended petition tendered.

4 *Docket Entries, No. 35,639.*

July 28—Motion for leave to file amended petition granted.

" 29—Copy of motion and amended petition served on General Counsel.

Aug. 31—Motion for continuance to December 2, 1931, filed by General Counsel. October 3, 1931, granted to December 7, 1931.

Sept. 28—Answer to amended petition filed by General Counsel.

5 Oct. 20—Application for order to take depositions filed by taxpayer.

" 26—Objection to issuance of an order to take depositions filed by General Counsel.

" 28—Motion to withdraw application filed by taxpayer. October 28, 1931, granted.

Nov. 9—Reply to answer filed by taxpayer. November 10, 1931, copy served.

" 24—Notice of change of hearing to December 2, 1931.

Dec. 2—Hearing had before Mr. Arundell on
6 merits. Dockets 35639-40-41-42-43-44-45-46-47-48-49, 35684-5, 40002, 40060-61-62 consolidated. Respondent's answer amended to amended petition to be filed. Interstate Commerce Commission reports filed. Stipulation read into record. Petitioner's brief due January 15, 1932; petitioner's reply March 1, 1932, and respondent's brief due February 15, 1932.

" 14—Transcript of hearing of December 2, 1931, filed.

" 18—Amendment to answer to amended petition filed by General Counsel.

Docket Entries, No. 35,639. 7

1932

Jan. 6—Stipulation of facts filed.
" 6—Stipulation as to schedules filed.
" 15—Brief and proposed findings filed by taxpayer.
" 16—Copy of brief and proposed findings served on General Counsel.
Feb. 8—Motion for extension to March 1, 1932, to file brief filed by General Counsel.
" 11—Order extending time to March 1, 1932, for respondent's brief and to March 15, 1932, for petitioner's reply entered. 8
" 29—Brief filed by General Counsel.
Mar. 14—Motion for extension to March 16, 1932, to file brief filed by taxpayer. March 15, 1932, granted.
" 16—Reply brief filed by taxpayer. March 17, 1932, copy served on General Counsel.
Apr. 14—Memorandum filed by General Counsel.
" 19—Memorandum filed by taxpayer.
Oct. 7—Opinion rendered—Mr. C. Rogers Arundell. Judgment will be entered under Rule 50. 9
" 24—Motion for review by full Board filed by taxpayer. October 25, 1932, denied.
Dec. 2—Agreed notice of settlement filed by taxpayer.
" 3—Decision entered—C. Rogers Arundell, Division 7.

1933

Jan. 21—Supersedeas bond in the amount of $12,000.00 approved and ordered filed.

Jan. 21—Petition for review by United States Circuit Court of Appeals, Second, with assignments of error filed by taxpayer.
" 21—Proof of service filed.
" 27—Praecipe filed.
" 27—Proof of service filed.
" 27—Statement of evidence lodged.
" 27—Notice of hearing on February 8, 1933, to approve statement filed.
11 " 31—Statement of evidence approved and ordered filed.
Feb. 24—Petition for review by United States Circuit Court of Appeals, Second Circuit, with assignments of error filed by General Counsel.
Mar. 2—Proof of service filed by General Counsel (3).

Docket Entries, No. 40,060.

12

UNION PACIFIC RAILROAD COMPANY, Petitioner, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 40060.

APPEARANCES:

For Petitioner: HENRY W. CLARK, ESQ., HARRY J. GERRITY, ESQ.

For Respondent: E. C. ALGIRE, ESQ.

1928

Aug. 2—Petition received and filed. Taxpayer notified.

" 3—Copy of petition served on General Counsel.

Sept. 17—Answer filed by General Counsel.

" 18—Copy served on taxpayer—General Calendar.

1931

Mar. 16—Hearing set May 6, 1931.

Apr. 6—Motion for continuance to October 21, 1931, filed by taxpayer. April 8, 1931, granted. 14

" 6—Notice of appearance of Harry J. Gerrity as attorney for the taxpayer filed.

June 9—Motion to consolidate with dockets 35639 to 35649, 35684-85, 40061 and 40062 filed by taxpayer. June 11, 1931, granted.

July 24—Motion for leave to file amended petition filed by taxpayer—amended petition tendered.

" 28—Motion for leave to file amended petition granted. 15

" 29—Copy of motion and amended petition served on General Counsel.

Aug. 31—Motion for continuance to December 2, 1931, filed by General Counsel. September 3, 1931, granted to December 7, 1931.

Sept. 28—Answer to amended petition filed by General Counsel.

Oct. 20—Application for order to take depositions filed by taxpayer.

" 26—Objection to issuance of an order to take depositions filed by General Counsel.

Oct. 28—Motion to withdraw application filed by taxpayer. October 28, 1931, granted.

Nov. 25—Notice of change of hearing to December 2, 1931.

Dec. 2—Hearing had before Mr. Arundell on the merits. Interstate Commerce Report filed. Stipulation read into record. Taxpayer's brief due January 15, 1932; Commissioner's brief due February 15, 1932. Reply brief due March 1, 1932.

17 " 14—Transcript of hearing of December 2, 1931, filed.

" 18—Amendment to answer to amended petition filed by General Counsel.

1932

Jan. 15—Brief and proposed findings filed by taxpayer.

" 16—Copy of brief and proposed findings served on General Counsel.

Feb. 8—Motion for extension to March 1, 1932, to file brief filed by General Counsel.

18 " 11—Order extending time to March 1, 1932, for respondent's brief and to March 15, 1932, for petitioner's reply entered.

" 29—Brief filed by General Counsel.

Mar. 14—Motion for extension to March 16, 1932, to file brief filed by taxpayer. March 15, 1932, granted.

" 16—Reply brief filed by taxpayer. March 17, 1932, copy served on General Counsel.

Apr. 16—Memorandum filed by General Counsel.

Oct. 7—Opinion rendered—C. Rogers Arundell, Division 7. Decision will be entered under Rule 50.

" 24—Motion for review by full Board filed by taxpayer. October 25, 1932, denied.

Dec. 2—Agreed notice of settlement filed by taxpayer.

" 3—Decision entered—C. Rogers Arundell, Division 7.

1933

Jan. 21—Supersedeas bond in the amount of $12,000.00 approved and ordered filed. 20

" 21—Petition for review by United States Circuit Court of Appeals, Second Circuit, with assignments of error filed by taxpayer.

" 21—Proof of service filed.

" 27—Praecipe filed.

" 27—Proof of service filed.

" 27—Statement of evidence lodged.

" 27—Notice of hearing on February 8, 1933, to approve statement filed.

" 31—Statement of evidence approved and ordered filed. 21

Feb. 24—Petition for review by United States Circuit Court of Appeals, Second Circuit, with assignments of error filed by General Counsel.

Mar. 2—Proof or service filed by General Counsel (3).

22

Amended Petition, No. 35,639.

UNITED STATES BOARD OF TAX APPEALS.

UNION PACIFIC RAILROAD COMPANY, OREGON SHORT LINE RAILROAD COMPANY, THE ST. JOSEPH AND GRAND ISLAND RAILWAY COMPANY, SAN FRANCISCO AND PORTLAND STEAMSHIP COMPANY, by OREGON-WASHINGTON RAILROAD & NAVIGATION COMPANY, successor, YAKIMA VALLEY TRANSPORTATION COMPANY, THE UNION PACIFIC COAL COMPANY, WASHINGTON UNION COAL COMPANY, OREGON AND WASHINGTON RAILROAD COMPANY, THE RATTLESNAKE CREEK WATER COMPANY, UNION PACIFIC WATER COMPANY, UNION PACIFIC EQUIPMENT ASSOCIATION, GREEN RIVER WATER WORKS COMPANY, PORTLAND TERMINAL INVESTMENT COMPANY, Petitioners, against COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket Number 35639.

23

24

The above named UNION PACIFIC RAILROAD COMPANY, OREGON SHORT LINE RAILROAD COM-

PANY, THE ST. JOSEPH AND GRAND ISLAND RAILWAY COMPANY, SAN FRANCISCO AND PORTLAND STEAMSHIP COMPANY (BY OREGON-WASHINGTON RAILROAD & NAVIGATION COMPANY, successor), YAKIMA VALLEY TRANSPORTATION COMPANY, THE UNION PACIFIC COAL COMPANY, WASHINGTON UNION COAL COMPANY, OREGON AND WASHINGTON RAILROAD COMPANY, THE RATTLESNAKE CREEK WATER COMPANY, UNION PACIFIC WATER COMPANY, UNION PACIFIC EQUIPMENT ASSOCIATION, GREEN RIVER WATER WORKS COMPANY AND PORTLAND TERMINAL INVESTMENT COMPANY, in amendment of their original petition herein filed on February 25, 1928, hereby petition this Board for a redetermination of the deficiencies of income tax liability for the year 1920, 1921 and 1922 found by the Commissioner of Internal Revenue, respondent, in his notices of deficiency addressed to them, respectively (IT:CR:RR:60D—JFK), dated December 29, 1927; and as the basis of this proceeding allege as follows:

I.

PETITIONER'S INCORPORATION.

The petitioners herein were in 1920, and still are, corporations of the following states: Union Pacific Railroad Company, Oregon Short Line Railroad Company, San Francisco and Portland Steamship Company, and Union Pacific Equipment Association, of the State of Utah; Oregon-Washington Railroad & Navigation Company, Oregon and Washington Railroad Company and Portland Terminal Investment Company, of the State of Oregon; The St. Joseph and Grand

Island Railway Company, of the States of Nebraska and Kansas; Yakima Valley Transportation Company and Washington Union Coal Company, of the State of Washington; The Union Pacific Coal Company, The Rattlesnake Creek Water Company, Union Pacific Water Company and Green River Water Works Company, of the State of Wyoming; except that said San Francisco and Portland Steamship Company was dissolved in 1926.

Petition Union Pacific Railroad Company has its office at No. 120 Broadway, New York City, New York, and the address of the other petitioners above named, for the purposes of these proceedings, is in the care of the Union Pacific Railroad Company at No. 120 Broadway, New York City,

II.

Deficiency Letters.

On the 29th day of December, 1927, respondent mailed to petitioner Union Pacific Railroad Company a letter dated on said day (a copy of which is hereto annexed, together with the statements accompanying the same as far as material to this proceeding, and marked Exhibit A), giving notice of his final determination that additional taxes are due from said petitioner for the years 1920, 1921 and 1922 under the Revenue Acts of 1918 and 1921 as set forth in said letter.

On the 29th day of December, 1927, respondent mailed to each of the other petitioners, respectively, a letter, dated on said day (copies of which are hereto annexed and marked Exhibits B to M), giving notice of his final determination that additional taxes are due from said peti-

tioners, respectively, for the years and in the amounts hereinafter stated, under the Revenue Acts of 1918 and 1921.

The several letters aforesaid, Exhibits A to M, are hereinafter collectively called the "deficiency letter".

III.

DEFICIENCIES FOUND.

The additional taxes found by the deficiency letter are income taxes for the calendar years 1920, 1921 and 1922 and are as follows: 32

1920.

Union Pacific R. R. Co.	$383,532.50
Oregon Short Line R. R. Co.	110,691.12
St. Joseph & Grand Island Ry. Co.	31,466.03
San Francisco & Portland S. S. Co.	3,220.25
Yakima Valley Transportation Co.	330.81
Union Pacific Coal Co.	20,225.19
Washington Union Coal Co.	797.06
Oregon & Washington R. R. Co.	139.06
Rattlesnake Creek Water Co.	291.69
Union Pacific Water Co.	221.04
Union Pacific Equipment Assn.	34.34
	$550,949.09

33

1921.

Union Pacific R. R. Co.	$ 92,111.48
Oregon Short Line R. R. Co.	9,726.24
Yakima Valley Transportation Co.	70.81
Union Pacific Coal Co.	46,950.85
Washington Union Coal Co.	18.61

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Oregon & Washington R. R. Co.	485.04
Union Pacific Water Co.	61.61
	$149,424.64

1922.

Union Pacific R. R. Co.	$815,199.50
Yakima Valley Transportation Co.	212.72
35 Union Pacific Coal Co.	4,027.75
Washington Union Coal Co.	742.93
Rattlesnake Creek Water Co.	276.20
Union Pacific Water Co.	337.09
Green River Water Works Co.	110.77
Portland Terminal Investment Co. ..	658.88
	$821,565.84

36 The entire amount of the deficiency for each of the years 1920, 1921 and 1922 is in controversy, and in addition petitioners claim to be entitled to refunds approximating the following:

For 1920	$ 57,000
For 1921	638,000
For 1922	110,000

IV.

Assignment of Errors.

Petitioners assert that in the redetermination of their tax liability for the years 1920, 1921 and

1922, as set forth in the deficiency letter, respondent has erred in the following particulars:

* * * * *

L. In refusing to allow the deduction for 1921 of losses on bonds of other companies exchanged by Union Pacific Railroad Company for bonds of the Los Angeles & Salt Lake Railroad Company under a contract with W. A. Clark.

* * * * *

P. In refusing to allow as deductions for 1920, 1921 and 1922 amortization of discount and commissions on bonds issued by Union Pacific Railroad Company and Oregon Short Line Railroad Company prior to 1913. 38

* * * * *

V.

Facts.

The facts upon which petitioners rely in support of the foregoing assignments of error are as follows:

39

General Allegations.

1. The petitioners were in each of the years 1920, 1921 and 1922 affiliated corporations within the meaning of Section 240 of the Revenue Acts of 1918 and 1921.

2. For the years 1920, 1921 and 1922 petitioner Union Pacific Railroad Company, as the parent company, made consolidated returns for itself and the petitioners, and for certain other corporations affiliated with it and with them, and the deficiencies found by respondent for each of said

40 years are computed upon the basis of said consolidated returns. The term "affiliated companies", as used in this petition, means said parent company and all the other corporations included in the consolidated return for the year in question, whether petitioners in that year or not.

3. The accounts of the petitioners and of all their affiliated companies were in the years 1920, 1921 and 1922 and theretofore kept upon the accrual basis.

41 4. In 1926 the San Francisco and Portland Steamship Company, theretofore a corporation of the State of Utah, one of the affiliated companies in the years 1920, 1921 and 1922, was dissolved by judicial decree and thereupon all its assets were surrendered to Oregon-Washington Railroad & Navigation Company, its sole stockholder, a corporation of the State of Oregon, another of the affiliated companies in each of said years, and said last named company thereupon assumed and agreed to pay all remaining debts and liabilities of said dissolved corporation.

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* * * * *
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L—Loss on Clark Trade—1921.

71. On April 27, 1921, Los Angeles & Salt Lake Railroad Company (hereinafter called the "Salt Lake Company") had outstanding an issue of First Mortgage 4 Per Cent. Bonds (hereinafter called the "Salt Lake Bonds"), one-half of which were owned by petitioner Oregon Short Line Railroad Company and the other half largely by one William A. Clark and members of his family.

72. By an agreement, dated April 27, 1921, between petitioner Union Pacific Railroad Company and said Clark said Union Pacific Railroad Company undertook and agreed to accept delivery from said Clark and said Clark agreed to deliver at least $25,000,000 face value, of said Salt Lake bonds in exchange for the following bonds to be delivered by said Union Pacific Railroad Company: (1) First and Refunding Mortgage 4 Per Cent. Bonds issued by the Oregon-Washington Railroad & Navigation Company (hereinafter called the "Navigation bonds"), one 44
of the affiliated companies, guaranteed by said Union Pacific Railroad Company, to a principal amount equal to 50 per cent. of the principal of the Salt Lake bonds so delivered to it; (2) First Refunding Mortgage 4 Per Cent. Bonds issued by the Southern Pacific Railroad Company to a principal amount equal to 30 per cent. of the principal of said Salt Lake bonds so delivered, and (3) San Francisco Terminal First Mortgage 4 Per Cent. Bonds issued by the Southern Pacific Company to a principal amount equal to 20 per cent. of the principal of the Salt Lake 45
bonds so delivered. The bonds described in Numbers (2) and (3) are hereinafter sometimes collectively called "Southern Pacific bonds".

73. By said agreement the Union Pacific Railroad Company also undertook to accept delivery of any and all additional Salt Lake bonds, and to make exchange therefor upon the same terms, whether tendered by said Clark or by other holders.

74. It was provided by said agreement also that, since said First Refunding Mortgage Bonds

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of the Southern Pacific Railroad Company were not issued in denominations of less than $500, face value, a cash adjustment would be made by petitioner Union Pacific Railroad Company for and in lieu of amounts of said bonds less than $500, face value, which would otherwise be deliverable upon exchanges made under said agreement.

75. Pursuant to said agreement petitioner
47 Union Pacific Railroad Company during 1921 delivered, in exchange for Salt Lake bonds, to the holders thereof $8,815,500, face value, of Southern Pacific Railroad Company's First Refunding Mortgage Bonds, $5,894,000, face value, of Southern Pacific Company's San Francisco Terminal First Mortgage Bonds and $14,735,000, face value, of Navigation bonds, and paid in cash in adjustment of undeliverable fractions of Southern Pacific Railroad Company's First Refunding Mortgage Bonds $23,630.14, receiving therefor $29,470,000, face value, of Salt Lake
48 bonds.

76. Said Salt Lake bonds at and before the time of their acquisition by petitioner Union Pacific Railroad Company upon the exchanges aforesaid had a readily realizable market value; and the fair market value of said Salt Lake bonds on April 27, 1921, and at the times of their acquisition by said petitioner upon the exchanges aforesaid during 1921 was not in excess of 72.15 per cent. of their face value.

77. The Southern Pacific bonds delivered in exchange for said Salt Lake bonds had been

49

acquired by said Union Pacific Railroad Company at an average cost of 91.47 per cent. of face value for the Southern Pacific Railroad Company First Refunding Mortgage Bonds and 87.50 per cent. of face value for the Southern Pacific Company San Francisco Terminal First Mortgage Bonds, and to the extent that they were acquired prior to March 1, 1913, their actual cost was less than the market values of said bonds on March 1, 1913.

50

78. Said Salt Lake bonds were not acquired by said Union Pacific Railroad Company as an investment, but as a means of acquiring the half interest in the Salt Lake R. R. theretofore owned by said Clark and so securing operating control of the railroads of that company. The primary purpose of said contract of April 27, 1921, was the sale by said Clark to said Union Pacific Railroad Company of 125,000 shares of the capital stock of said Salt Lake Company, constituting the half of its entire stock, owned by him or his associates and family, and being

51

all of the stock of said Company not already owned by petitioner Oregon Short Line Railroad Company. Said Clark was not willing to dispose of his stock interest in the said Salt Lake Company without disposing of his holding of the bonds of said company and made it also a condition of said contract that other holders of said bonds should have the privilege of disposing of their bonds upon the same terms.

79. The Navigation bonds delivered by Union Pacific Railroad Company in exchange for Salt Lake bonds as aforesaid had been acquired by

Union Pacific Railroad Company in 1914 from the Oregon Short Line Railroad Company at 90 per cent. of their face value; and said Navigation bonds were not acquired or held by said Union Pacific Railroad Company as an investment, but were held primarily for the purpose of sale to the public to finance capital requirements of said petitioner and its affiliated companies.

80. There were outstanding in the hands of the public a large amount of said Southern Pacific bonds and Navigation bonds, additional to the bonds of those issues delivered as aforesaid by said Union Pacific Railroad Company to said Clark, and of the same issues as the bonds so delivered by it, and all of said issues were dealt in extensively on the New York Stock Exchange and had readily ascertainable market values. The market values of said bonds on the New York Stock Exchange on April 27, 1921, were: 75½ for said Southern Pacific Railroad Company First Refunding Mortgage Bonds, 71¼ for said Southern Pacific Company San Francisco Terminal First Mortgage Bonds and 70½ for said Navigation bonds.

81. Petitioner Union Pacific Railroad Company suffered losses upon the Southern Pacific bonds and Navigation bonds delivered by it to said Clark and others in exchange for Salt Lake bonds in 1921 as follows:

Delivered:

$8,815,500,	face value, Southern Pacific R. R. Co. 1st Refunding Mortgage Bonds, cost at 91.47	$8,063,537.85

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$5,894,000, face value, Southern Pacific Co. San Francisco Terminal First Mortgage Bonds, cost at 87.50		5,157,250.00
$14,735,000, face value, Navigation Bonds, cost at 90		13,261,500.00
Total cost		$26,482,287.85
Received:		
$29,470,000, face value, Salt Lake Bonds, worth at 72.15	$21,262,605.00	56
Less:		
Cash adjustment	23,630.14	
		21,238,974.86
Loss		$5,243,312.99

82. In the redetermination of the consolidated tax liability for 1921 respondent has refused to allow the aforesaid losses as deductions from the consolidated gross income. 57

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* * * * *
* * * * *

P—Prior-to-1913 Bond Discount—1920, 1921, 1922.

Convertible Bonds:

99. In 1907 petitioner Union Pacific Railroad Company made an issue of its corporate bonds designated as its 20-Year Convertible 4 Per Cent. Bonds, maturing July 1, 1927, and offered the same to its stockholders for *pro rata* subscription on July 10, 1907, at the subscription price of 90.

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100. In order to insure the sale of said bonds, a firm of bankers at the request of said petitioner formed an underwriting syndicate which guaranteed the sale of said bonds at the price at which they were to be offered to stockholders, said petitioner undertaking to pay a commission of two per cent. to said syndicate and a commission of one-half of one per cent. to said bankers as syndicate managers, computed upon the total amount of said bonds so offered.

59 101. The stockholders of said petitioner failed to exercise their subscription rights, except as to a comparatively small amount of said bonds, and said syndicate was required to purchase under its guaranty most of said issue, paying therefor the subscription price of 90 less their commission of 2 per cent.

102. Prior to January 1, 1920, said Convertible bonds had been reduced by conversions thereof into stock to the amount of $26,835,225, which amount was outstanding throughout the years
60 1920, 1921 and 1922, on which the difference of 12 per cent. (hereinafter called "discount") between the face value of said bonds and the price paid therefor by said syndicate was $3,220,227 and the banker's commission of one-half of one per cent. was $134,176.

103. Amortizing the aforesaid discount and commissions on said Convertible bonds over the 20 year life of said bonds gives the amount of $161,011.35 as the yearly amortization of said discount and $6,708.80 as the yearly amortization of said bankers commission.

104. No part of the aforesaid yearly amortization of discount and commissions on said Convertible bonds has been allowed as a deduction by the deficiency letter for any of the years under review.

First Lien & Refunding Bonds:

105. In 1908 petitioner Union Pacific Railroad Company made an issue of its corporate bonds designated as its First Lien & Refunding 4 Per Cent. Bonds, maturing June 1, 2008, and in June of that year $30,000,000, face value, and £4,000,000, face value, thereof were sold to the public by a firm of bankers for the account of said petitioner at the price of 95½, said bankers receiving a commission of 2½ per cent. 62

106. The discount suffered upon said $30,000,000, face value, and £4,000,000, face value, of First Lien & Refunding Bonds amounted to $2,185,878.88 and said bankers commission to $1,214,377.16, which amortized over the 100 year life of said bonds gives the amount of $21,858.78 as the yearly amortization of said discount and $12,143.77 as the yearly amortization of said commissions. 63

107. Petitioner Union Pacific Railroad Company in June, 1909, sold additional of its First Lien & Refunding bonds to petitioner Oregon Short Line Railroad Company, to the amount of $6,402,000, face value, at the price of 98 and to the amount of $2,000,000, face value, at the price of 97½, and said bonds were during the following year resold by said Oregon Short Line Rail-

road Company to bankers in part at the same price and in part at a lower price.

108. The discount upon the $8,402,000, face value, of bonds sold to Oregon Short Line Railroad Company as aforesaid was $178,040 which amortized over the 99 years of the remaining life of said bonds gives the amount of $1,798.38 as the yearly amortization of said discount.

65 109. In September, 1910, petitioner Union Pacific Railroad Company sold to bankers additional of its said First Lien & Refunding Bonds to the amount of £1,000,000, face value, at the price of 93 and to the amount of £500,000, face value, at the price of 95, and said sales to bankers were absolute sales and involved no commissions.

110. The discount suffered upon the sale of said £1,500,000 of said bonds in September, 1910, amounted to $440,397.50, which amortized over
66 the 98 years of the remaining life of said bonds gives the amount of $4,493.85 as the yearly amortization of said discount.

111. All the First Lien & Refunding bonds sold as aforesaid were outstanding in the hands of the public throughout the years under review, but of the aggregate of $28,151.01 of yearly amortization of discount and $12,143.77 of yearly amortization of commissions upon the aforesaid sales of First Lien and Refunding Bonds only $22,865.81 of discount amortization has been allowed by the deficiency letter as a deduction in each of the years under review.

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O. S. L. Refunding Bonds:

112. In October, 1904, petitioner Oregon Short Line Railroad Company called for redemption, effective February 1, 1905, its issue of Participating 4 per cent. bonds of which $36,500,000, face value, were outstanding, and arranged to refund the same by making a new issue of its Refunding 4 Per cent. bonds, maturing December 1, 1929.

113. At the request of said petitioner a firm of 68
bankers formed a syndicate which guaranteed the sale of $40,000,000, face value, of said Refunding bonds at the price of 96, subject to an offer to the holders of Participating Bonds of a right to subscribe for said Refunding bonds, at the price of 96 and to receive in cash the difference between that price and the redemption price of their Participating bonds.

114. Said petitioner agreed to pay said syndicate a commission of 2 per cent. and said bankers as syndicate managers a commission of 1 per 69
cent., upon the face value of said Refunding bonds so underwritten.

115. Said bankers published in October, 1904, in their own names, the offer aforesaid to holders of Participating bonds, and somewhat less than $28,000,000, face value, of said Refunding bonds were subscribed for by the holders of Participating bonds, pursuant to said offer.

116. The balance of said issue of Refunding bonds, at least $12,000,000, face value, was taken by said syndicate pursuant to its guaranty, pay-

70 ing therefor the price of 96 less its commission of 2 per cent.

117. The discount of 4 per cent. upon the $28,000,000 of said Refunding bonds taken by the Participating bondholders amounted to $1,-120,000; the difference of 6 per cent. (hereinafter also called "discount") between the price paid for said $12,000,000 of Refunding bonds by the syndicate and the face value thereof amounted to $720,000; and the 2 per cent. commission of
71 the syndicate upon the $28,000,000 of said bonds taken by the Participating bondholders and the 1 per cent. commission of the bankers upon the entire $40,000,000 of bonds together amounted to $960,000.

118. Amortizing over the 25 year life of said Refunding bonds the aforesaid discount and commissions, respectively, gives the amount of $73,-600 as the yearly amortization of said discount and $38,400 as the yearly amortization of said commissions.

72 119. In June, 1905, said Oregon Short Line Railroad Company sold to petitioner Union Pacific Railroad Company additional of said Refunding bonds to the amount of $5,0000,000, face value, at the price of 94, which said Union Pacific Railroad Company within the following year resold to bankers.

120. The discount on the $5,000,000 of said bonds sold to Union Pacific Railroad Company as aforesaid was $300,000, which amortized over the 25 year life of said bonds gives the amount of $12,000 as the yearly amortization of said discount.

121. All of said $45,000,000 of Refunding bonds were outstanding in the hands of the public throughout the years under review; but no part of the $124,000 of yearly amortization of the aforesaid discount and commissions has been allowed by the deficiency letter as a deduction in any of said years.

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VI. 74

RELIEF PRAYED.

Petitioners pray that their income tax liability for 1920, 1921 and 1922 be redetermined by the Board and that over payments be found for each of said years, resulting from relief upon the several errors herein assigned and the facts pleaded in support thereof, viz.:

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75

WHEREFORE, petitioners pray that this Board hear and determine their tax liabilities upon the issues herein set forth.

Dated: July 23, 1931.

HENRY W. CLARK,
120 Broadway, New York, N. Y.

HARRY J. GERRITY,
Hill Building, Washington, D. C.,
Counsel for Petitioners.

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76 **Answer to Amended Petition, No. 35,639.**

(Filed Sept. 28, 1931.)

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Docket Number 35639.

Comes now the Commissioner of Internal Revenue, through his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, and for answer to the amended petition of this taxpayer admits and denies as follows:

I.

77 Admits the allegations contained in Part I of the amended petition.

II.

Admits the allegations contained in the first paragraph of Part II of the amended petition except that it is denied that Exhibit A is a copy of the deficiency letter so far as material to this proceeding.

Admits the allegations contained in the second and third paragraphs of Part II of the amended
78 petition.

III.

Admits the allegations contained in Part III of the amended petition except that it is denied that the amounts of taxes in controversy for the respective years is correctly stated therein.

IV.

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K to P, inclusive. Denies that error was committed as alleged in subdivisions K to P, inclusive, of Part IV of the amended petition.

79

V.

GENERAL ALLEGATIONS.

1, 2, 3, and 4. Admits the allegations contained in paragraphs 1, 2, 3, and 4 under this heading of Part V of the amended petition.

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L—Loss on Clark Trade—1921.

71. Admits the allegations contained in paragraph 71 under this heading of Part V of the amended petition. 80

72, 73, and 74. Denies the allegations contained in paragraphs 72, 73, and 74 under this heading of Part V of the amended petition for the reason that the agreement referred to is the best evidence of the provisions thereof.

75 and 76. Admits the allegations contained in paragraphs 75 and 76 under this heading of Part V of the amended petition.

77. Admits the allegations contained in paragraph 77 under this heading of Part V of the amended petition except, for lack of information necessary to form a belief as to the truth or falsity thereof, it is denied that to the extent Southern Pacific Railroad Company First Refunding Mortgage Bonds and Southern Pacific Company San Francisco Terminal First Mortgage Bonds were acquired prior to March 1, 1913, their actual cost was less than the market, values of said bonds on March 1, 1913. 81

78. Denies the allegations contained in paragraph 78 under this heading of part V of the amended petition.

82 *Answer to Amended Petition, No. 35,639.*

79. Admits that the Navigation Bonds delivered by the Union Pacific Railroad Company in exchange for Salt Lake Bonds had been acquired by the Union Pacific Railroad Company in 1914, from the Oregon Short Line Railroad Company at 90 per cent. of the face value as alleged in paragraph 79 under this heading of Part V of the amended petition, but denies that the Navigation Bonds were not acquired or held by said Union Pacific Railroad Company as an
83 investment, and denies that they were held primarily for the purpose of sale to the public to finance capital requirements as alleged.

80. Admits the allegations contained in paragraph 80 under this heading of Part V of the amended petition.

81. Denies the allegations contained in paragraph 81 under this heading of Part V of the amended petition.

82. Admits the allegations contained in paragraph 82 under this heading of Part V of the
84 amended petition.

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P—Prior to 1913 Bond Discount—1920, 1921, 1922.

99 to 121, inclusive. Admits the allegations contained in paragraphs 99 to 121, inclusive, under this heading of Part V of the amended petition.

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Amended Petition, No. 40,060. 85

WHEREFORE, it is prayed that the appeal be denied except in so far as error is conceded herein, or if the rental interest is legally considered as constituting taxable income for the Federal control period, the alternative relief herein requested be granted as to that issue and that the affirmative relief herein requested be granted.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

of Counsel: 86

E. C. ALGIRE,
Special Attorney,
Bureau of Internal Revenue.

ECA:RBI

Amended Petition, No. 40,060.

(Filed July 28, 1931.)

UNITED STATES BOARD OF TAX APPEALS. 87

UNION PACIFIC RAILROAD COMPANY, LOS ANGELES & SALT LAKE RAILROAD COMPANY, DES CHUTES RAILROAD COMPANY, Petitioners, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 40,060.

The above-named UNION PACIFIC RAILROAD COMPANY, LOS ANGELES & SALT LAKE RAILROAD COMPANY and DES CHUTES RAILROAD COMPANY,

88 *Amended Petition, No. 40,060.*

petitioners, hereby petition, in amendment of their original petition filed herein on August 2, 1928, for a redetermination of their income tax liability and of the deficiencies found by the Commissioner of Internal Revenue, respondent, in his deficiency letters addressed to them, respectively (IT:AR:RR—60D:MB), dated June 6, 1928.

I.

PETITIONERS.

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The petitioners herein were in 1923 and still are corporations of the following States: Union Pacific Railroad Company and Los Angeles & Salt Lake Railroad Company, of the State of Utah; Des Chutes Railroad Company, of the State of Oregon.

Petitioner Union Pacific Railroad Company has its office at No. 120 Broadway, New York City, New York, and the address of the other petitioners above-named, for the purposes of this proceeding, is in the care of Union Pacific
90 Railroad Company at No. 120 Broadway, New York City, New York.

II.

DEFICIENCY LETTERS.

On the 6th day of June, 1928, respondent mailed to petitioner Union Pacific Railroad Company a letter, dated on said day (a copy of which is hereto annexed, together with the supporting statements which accompanied it, as far as they are material to this proceeding, and marked Exhibit A) giving notice of his final

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determination that additional taxes are due from said petitioner for the year 1923.

On the 6th day of June, 1928, respondent mailed to petitioner Los Angeles & Salt Lake Railroad Company a letter, dated on said day (a copy of which is hereto annexed and marked Exhibit Y), giving notice of his final determination that additional taxes are due from said petitioner for the year 1923.

On the 6th day of June, 1928, respondent mailed to petitioner Des Chutes Railroad Company a letter, dated on said day (a copy of which 92
is hereto annexed and marked Exhibit Z), giving notice of his final determination that additional taxes are due from said petitioner for the year 1923.

Said letters, Exhibits A (with its accompanying statements), Y and Z, are hereinafter collectively called the "deficiency letter".

III.

DEFICIENCIES FOUND.

93

The additional taxes proposed by the deficiency letter to be assessed are income taxes for the calendar year 1923 and are as follows:

Union Pacific Railroad Company	$42,313.87
Los Angeles & Salt Lake Railroad Company	53,028.76
Des Chutes Railroad Company	140.80
Total	$95,483.43

The entire amount of the proposed deficiencies is in controversy and in addition petitioner Union Pacific Railroad Company claims to be

94 *Amended Petition, No. 40,060.*

entitled to a refund for the consolidated group of $79,653.25.

IV.

ASSIGNMENT OF ERRORS.

Petitioners assert that in the redetermination of their income tax liability for the year 1923, as set forth in the deficiency letter, respondent has erred in the following particulars:

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95 H. In refusing to allow the deduction of the annual amortization of discount and commissions on bonds issued prior to 1913.

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V.

FACTS.

The facts upon which petitioners rely in support of the foregoing assignments of error are
96 as follows:

1. The petitioners were throughout the year 1923 affiliated companies within the meaning of Section 240 of the Revenue Act of 1921.

2. For the year 1923 petitioner Union Pacific Railroad Company, as the parent company, made a consolidated return for itself and the other petitioners herein named and for certain other corporations affiliated with it and with them, and the deficiencies found by respondent as hereinbefore alleged are computed upon the basis of said consolidated return. The term "affiliated companies" as used in this petition means said

parent company and all the other corporations included in said consolidated return, whether petitioners herein or not.

3. The accounts of the petitioners and of all other affiliated companies were for the year 1923 and theretofore kept upon the accrual basis.

4. On the 18th day of September, 1925, and the 12th day of March, 1928, petitioner Union Pacific Railroad Company filed claims for refund of $72,487.01 and $142,619.58, respectively, of the consolidated tax paid by it for the year 1923 for itself and its affiliated companies. 98

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H—Prior-to-1913 Bond Discount.

Convertible Bonds:

42. In 1907 petitioner Union Pacific Railroad Company made an issue of its corporate bonds designated as its 20-Year Convertible 4 Per cent. Bonds, maturing July 1, 1927, and offered the same to its stockholders for *pro rata* subscription on July 10, 1907, at the subscription price of 90, the subscription rights so offered aggregating $73,762,000. of bonds. 99

43. In order to insure the sale of said bonds, a firm of bankers at the request of said petitioner formed an underwriting syndicate which guaranteed the sale of said bonds at the price at which they were to be offered to stockholders, said petitioner undertaking to pay a commission of two per cent. to said syndicate and a commission of one-half of one per cent. to said bankers as

100 *Amended Petition, No. 40,060.*

syndicate managers, computed upon the total amount of said bonds so offered.

44. The stockholders of said petitioner failed to exercise their subscription rights, except as to a comparatively small amount of said bonds, and said syndicate was required to purchase under its guaranty most of said issue, paying therefor the subscription price of 90 less its commission of 2 per cent.

101 45. Prior to January 1, 1923, said Convertible bonds had been reduced by conversions thereof into stock to the amount of $26,835.225, which amount was outstanding throughout the year 1923, on which the difference of 12 per cent. (hereinafter called "discount") between the face value of said bonds and the price paid therefor by said syndicate was $3,220,227 and the bankers' commission of one-half of one per cent. was $134,176.

102 46. Amortizing the aforesaid discount and commissions on said Convertible bonds over the 20 year life of said bonds gives $161,011.35 as the yearly amortization of said discount, and $6,708.80 as the yearly amortization of said bankers' commission, no part of which amortization of discount and commissions on said Convertible bonds has been allowed as a deduction by the deficiency letter.

First Lien & Refunding Bonds:

47. In 1908 petitioner Union Pacific Railroad Company made an issue of its corporate bonds designated as its First Lien & Refunding 4 Per

cent. Bonds, maturing June 1, 2008, and in June of that year $30,000,000, face value, and £4,000,000, face value, thereof, were sold to the public by a firm of bankers for the account of said petitioner at the price of 95½, said bankers receiving a commission of 2½ per cent.

48. The discount suffered upon said $30,000,000, face value, and £4,000,000, face value, of First Lien & Refunding Bonds amounted to $2,185,878.88 and said bankers' commission to $1,214,377.16, which amortized over the 100 year 104
life of said bonds give $21,858.78 as the yearly amortization of said discount and $12,143.77 as the yearly amortization of said commissions.

49. Petitioner Union Pacific Railroad Company in June, 1909, sold additional of its First Lien & Refunding bonds to petitioner Oregon Short Line Railroad Company, to the amount of $6,402,000, face value, at the price of 98, and to the amount of $2,000,000, face value, at the price of 97½, and said bonds were during the following year resold by said Oregon Short Line Rail- 105
road Company to bankers in part at the same price and in part at a lower price.

50. The discount upon the $8,402,000, face value, of said bonds sold to Oregon Short Line Railroad Company as aforesaid was $178,040, which amortized over the 99 years of the remaining life of said bonds gives $1,798.38 as the yearly amortization of said discount.

51. In September, 1910, petitioner Union Pacific Railroad Company sold to bankers additional of its said First Lien & Refunding bonds

to the amount of £1,000,000, face value, at the price of 93, and to the amount of £500,000, face value, at the price of 95, and said sales to bankers were absolute sales and involved no commissions.

52. The discount suffered upon the sale of said £1,500,000 of said bonds in September, 1910, amounted to $440,397.50, which amortized over the 98 years of the remaining life of said bonds
107 gives $4,493.85 as the yearly amortization of said discount.

53. All the First Lien & Refunding bonds sold as aforesaid were outstanding in the hands of the public throughout the year 1923, but of the aggregate of $28,151.01 of yearly amortization of discount and $12,143.77 of yearly amortization of commissions upon the aforesaid sales of First Lien & Refunding bonds only $22,865.81 of discount amortization has been allowed by the deficiency letter as a deduction in said year.

108 *O. S. L. Refunding Bonds:*

54. In October, 1904, Oregon Short Line Railroad Company, one of the affiliated companies, called for redemption, effective February 1, 1905, its issue of Participating 4 per cent. bonds of which $36,500,000, face value, were outstanding and arranged to refund the same by making a new issue of its Refunding 4 Per cent. bonds, maturing December 1, 1929.

55. At the request of said affiliated company a firm of bankers formed a syndicate which guaranteed the sale of $40,000,000, face value, of

said Refunding bonds at the price of 96, subject to an offer to the holders of Participating bonds of a right to subscribe for said Refunding bonds at the price of 96 and to receive in cash the difference between that price and the redemption price of their Participating bonds.

56. Said affiliated company agreed to pay said syndicate a commission of 2 per cent. and said bankers as syndicate managers a commission of 1 per cent., upon the face value of said Refunding bonds so underwritten. 110

57. Said bankers published in October, 1904, in their own names, the offer aforesaid to holders of Participating bonds, and somewhat less than $28,000,000, face value, of said Refunding bonds were subscribed for by the holders of Participating bonds, pursuant to said offer.

58. The balance of said issue of Refunding bonds, at least $12,000,000, face value, was taken by said syndicate, pursuant to its guaranty, paying therefor the price of 96 less its commission of 2 per cent. 111

59. The discount of 4 per cent. upon the $28,000,000 of said Refunding bonds taken by the Participating bondholders amounted to $1,120,000; the difference of 6 per cent. (hereinafter also called "discount") between the price paid for said $12,000,000 of Refunding bonds by the syndicate and the face value thereof amounted to $720,000; and the 2 per cent. commissions of the syndicate upon the $28,000,000 of said bonds taken by the Participating bondholders and the 1 per cent. commission of the bankers upon the entire $40,000,0000 of bonds together amounted to $960,000.

112 *Amended Petition, No. 40,060.*

60. Amortization over the 25 year life of said Refunding bonds the aforesaid discount and commissions, respectively, gives $73,600 as the yearly amortization of said discount and $38,400 as the yearly amortization of said commissions.

61. In June, 1905, said Oregon Short Line Railroad Company sold to petitioner Union Pacific Railroad Company additional of said Refunding bonds to the amount of $5,000,000, face
113 value, at the price of 94, which said Union Pacific Railroad Company within the following year resold to bankers.

62. The discount on the $5,000,000 of said bonds sold to Union Pacific Railroad Company as aforesaid was $300,000, which amortized over the 25 year life of said bonds gives $12,000 as the yearly amortization of said discount.

63. All of said $45,000,000 of Refunding bonds were outstanding in the hands of the public throughout the year 1923; but no part of the
114 $124,000 of yearly amortization of the aforesaid discount and commissions has been allowed by the deficiency letter as a deduction in said year.

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VI.

Relief Prayed.

Petitioners pray that their income tax liability for the year 1923 be redetermined by this

Board, and that the deficiencies proposed by the deficiency letter be reversed and an overpayment determined, resulting from relief upon the several errors herein assigned and the facts pleaded in support thereof, viz:

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* * * * *

WHEREFORE, petitioners pray that this Board hear and determine their tax liability upon the issues herein set forth.

Dated, July 23, 1931.

HENRY W. CLARK,
120 Broadway,
New York City, N. Y.,

HARRY J. GERRITY,
Hill Building,
Washington, D. C.,
Counsel for Petitioners.

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Answer to Amended Petition, No. 40,060.

(Filed September 28, 1931.)

Docket Number 40060.

The Commissioner of Internal Revenue by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the amended petition filed by the above named petitioners, admits and denies as follows:

118 *Answer to Amended Petition, No. 40,060.*

I

Admits the allegations contained in Part I of the amended petition.

Admits the allegations contained in the first paragraph of Part II of the amended petition except that it is denied that Exhibit A is a copy of the deficiency letter so far as material to this proceeding.

Admits the allegations contained in the second, third, and fourth paragraph of Part II of the
119 amended petition.

III.

Admits the allegations contained in Part III of the amended petition except that it is denied that the taxes in controversy are correctly stated therein.

IV.

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E to H, inclusive. Denies that error was com-
120 mitted as alleged in paragraphs E to H, inclusive, of Part IV of the amended petition.

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V.

1, 2, 3 and 4. Admits the allegations contained in paragraphs 1, 2, 3 and 4 of Part V of the amended petition.

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* * * * *

Opinion.

121

H-Prior-to-1913 Bond Discount.

42 to 63, inclusive. Admits the allegations contained in paragraphs 42 to 63, inclusive, under this heading of Part V of the amended petition.

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WHEREFORE, it is prayed that the petitioners' appeal be denied.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue. 122

Of Counsel:

E. C. ALGIRE,
Special Attorney,
Bureau of Internal Revenue.
ECA:RBI

Opinion.

Docket Nos. 35639 and 40060.

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123

Loss: Exchange of bonds for bonds: In 1921 the Union Pacific Railroad Company exchanged bonds of three other companies, which bonds it had acquired by purchase, for bonds of the Los Angeles & Salt Lake Railroad Company, the fair market value of which was less than the cost of the bonds given in exchange. *Held* that the exchange was one on which no gain or loss is recognized under Section 202 of the Revenue Act of 1921.

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124 *Opinion.*

Amortization of discount and commissions on bonds issued prior to 1913: Held that discount on bonds issued prior to 1913 may be amortized over the life of the bonds. Further *held*, that commissions paid on the sale of such bonds may not be amortized and no deduction therefor is allowable in the taxable years.

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125 OPINION.

ARUNDELL: These proceedings involve deficiencies in income taxes of the Union Pacific Railroad Company and its affiliated corporations for the years 1920 to 1923, inclusive, in an aggregate amount of $1,617,423. Docket No. 40002 is a transferee proceeding, which the parties agree is disposed of by their stipulation that any deficiency shall be allocated wholly to the parent, the Union Pacific Railroad Company. The transferee liability asserted by the respondent is in
126 the amount of $3,220.25.

The petitions filed allege twenty-five errors, of which fourteen, and an affirmative defense presented by respondent, have been disposed of by confession, abandonment, or stipulation. The matters so disposed of are set forth in petitioner's brief and are agreed to by respondent in his brief. They are incorporated herein by reference and will be given effect under Rule 50.

Most of the facts relating to the remaining eleven issues have been agreed upon through the medium of respondent's acquiescence in the findings proposed by petitioners. We will set out the several issues to be decided, numbered and

lettered as they appear in the pleadings and briefs, and under each one give only a summary of the facts sufficient for an understanding of the question presented.

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Issue L. Whether the Union Pacific Railroad Company sustained a deductible loss in 1921 through the exchange of bonds of other companies for bonds of the Los Angeles & Salt Lake Railroad Company under a contract with W. A. Clark. 128

Prior to the transaction hereinafter described the Union Pacific Railroad Company, hereinafter called Union Pacific, owned all the stock of the Oregon Short Line Railroad Company, hereinafter called Oregon Short Line. The latter company, Oregon Short Line, in turn owned (1) all the stock of the Oregon-Washington Railroad & Navigation Company, hereinafter called Navigation Company, and (2) one-half the stock and bonds of the Los Angeles & Salt Lake Railroad 129 Company, hereinafter called the Salt Lake Company. The remaining one-half of the stock and bonds of the Salt Lake Company were owned largely by W. A. Clark and members of his family. The total issue of Salt Lake stock was 250,000 shares, and the total outstanding issue of bonds, which were 4 per cent., first mortgage bonds, amounted to something over $58,000,000 face value.

Under date of April 27, 1921, the Union Pacific and Clark entered into an agreement by which the Union Pacific agreed to buy the 125,000 shares of Salt Lake Company stock then owned by Clark and his family at $20 a share.

By the same agreement the Union Pacific agreed to accept delivery from Clark, and Clark agreed to deliver at least $25,000,000 face value of Salt Lake Company bonds in exchange for the following bonds to be delivered by the Union Pacific: (1) Navigation Company first and refunding mortgage 4 per cent. bonds, guaranteed by the Union Pacific, to a principal amount equal to 50 per cent. of the principal of the Salt Lake bonds delivered; (2) Southern Pacific Railroad Company first refunding mortgage 4 per cent. bonds to a principal amount equal to 30 per cent. of the principal of the Salt Lake bonds delivered; (3) San Francisco Terminal first mortgage 4 per cent. bonds, issued by the Southern Pacific Company to a principal amount equal to 20 per cent. of the principal of the Salt Lake bonds delivered.

By the same agreement the Union Pacific also agreed to accept delivery of any and all additional Salt Lake bonds, and to make exchange therefore upon the same terms, whether tendered by Clark or by other holders. The agreement also provided for a cash adjustment by the Union Pacific in lieu of undeliverable fractions of the Southern Pacific bonds called for upon the exchanges.

Pursuant to the agreement, during 1921 bonds of the Salt Lake Company of the face value of $29,470,000 were delivered to the Union Pacific which gave in exchange therefor the following bonds:

	Face Value	*Cost to Union Pacific*
Navigation Company bonds	$14,735,000	$13,261,500.00
Southern Pacific Company bonds	8,815,500	8,063,537.85
San Francisco Terminal bonds	5,894,000	5,157,250.00

Some of the bonds delivered by the Union Pacific had been acquired by it prior to March 1, 1913, and as to such bonds cost was lower than fair market value at March 1, 1913. The Salt Lake bonds acquired by the Union Pacific in 1921 had a readily realizable value, and the fair market value at the time of acquisition by the Union Pacific was not in excess of 72.15 of their face value, or an aggregate value of $21,262,605.

The difference between the cost to the Union Pacific of the bonds delivered by it in exchange for the Salt Lake bonds in 1921, and the market value of the Salt Lake bonds received was as follows:

Delivered by Union Pacific:		
Navigation bonds (Cost)	$13,261,500.00	
Southern Pacific bonds (Cost)	8,063,537.85	
San Francisco Terminal bonds (Cost)	5,157,250.00	
Total cost		$26,482,287
Received by Union Pacific:		
Salt Lake bonds (Value)	$21,262,605.00	
Less cash adjustment	23,630.14	21,238,974
Difference		$ 5,243,312

The Navigation Company bonds exchanged for Salt Lake bonds in 1921, were acquired by the Union Pacific in 1914 in anticipation of legislation which was expected to impose restrictions on the issuance of securities, and the Union Pacific contemplated guaranteeing and selling them at some future time. After the bonds were acquired by the Union Pacific there was no satisfactory market for them in view of their low interest rate, and, as the company had other

resources, it continued to hold the bonds until the time of the exchange in 1921.

The Union Pacific had two objects in view in entering into the contract of April 27, 1921. One was to gain operating control of the Salt Lake railroad. As matters stood before the exchange in 1921, half of the Salt Lake Company directors were elected by the Clark interests and half by Union Pacific interests. Clark was president of the company. These two interests were har-
137 monious, but the Union Pacific deemed it advisable to secure sole control so as to have all operating matters and traffic arrangements exclusively under its direction, and also for the purpose of having its own entrance into southern California which it did not then have. The other object was to place the Union Pacific in better position for further financing when needed. The Union Pacific had no mileage available upon which to place first liens for new financing, and so it was considered advisable to acquire the Salt Lake bonds which could then
138 be cancelled and the mortgage discharged, and thus have available substantial mileage against which to issue new first mortgage bonds. The Union Pacific never contemplated selling the Salt Lake bonds, and it still holds them.

Petitioner Union Pacific contends that the difference between the cost of the bonds delivered by it in 1921 and the value of the Salt Lake bonds received by it in the exchange above described constituted a deductible loss in 1921. The parties are agreed upon the basic figures, but respondent contends that the exchange was one under which gain or loss is not recognized by the Revenue Act of 1921 and the Regulations issued thereunder.

The applicable section of the Revenue Act is Section 202, subsections (c) and (c)(1) as follows:

> For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recog- 140
> nized—
>
> When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use.

Petitioner's contention is that the exchange was not an exchange of property held for investment or productive use in trade or business for property of a like kind or use, hence the loss sustained on the exchange is one that is recog- 141
nized by the Revenue Act.

In the argument the exchange is separated into two parts, first, the exchange of the Navigation Company bonds, and second, the exchange of the Southern Pacific and San Francisco Terminal bonds.

Petitioner argues that the Navigation Company bonds were held primarily for sale, hence they come within the exception in Section 202 (c)(1), and further that bonds of a wholly-owned subsidiary are not held by the parent as an investment or for productive use because the ownership of the stock insures to the parent

142 *Opinion.*

the realization of the net income of the subsidiary available for distribution. Under Section 202(c)(1) gain or loss is recognized on an exchange involving "stock-in-trade or other property held primarily for sale". We find considerable difficulty in accepting petitioner's view that the Navigation bonds were property held primarily for sale. The evidence is that the Union Pacific acquired the bonds originally in the hope of having them for sale free from the restriction
143 of the then anticipated legislation for the regulation of the issuance of securities. But from 1914 to 1921 the petitioner continued to own and hold the bonds. There is no evidence that it made any attempt to sell them. There is testimony that after they were acquired there was practically no market for 4 per cent. bonds. We should like more information than this. We are not informed to what extent the market for such bonds dropped. For all we know it might have been possible for the Union Pacific to have disposed of the bonds at a profit even though the
144 market for such bonds fell somewhat. Granting that the Navigaion bonds were acquired with the intent of ultimately selling them, it does not follow that they were not held in the meantime for investment. The two objectives are not inconsistent. Nor do we think that the ownership of all the stock of the subsidiary is determinative of whether the bonds were held as an investment. Had any of the bonds been held by outside interest the earnings available for distribution to the parent would have been reduced by the amount of interest on such bonds. Under the rule of "*ejusdem generis*" we construe the phrase "or other property" as including prop-

erty of the same general nature as stock-in-trade, that is, property acquired for sale and openly and continuously offered for sale to the public. Stocks or bonds might well be considered the stock in trade of a dealer in securities. But dealing in securities was not the business of petitioner in this case. The fact that it proposed at some time to dispose of the bonds, after enhancing their value by endorsement, in our opinion does not bring petitioner within the intent of the statute. The burden of proof is on petitioner to establish that the Navigation bonds 146
were not held for investment. *R. D. Davis,* 21 B. T. A. 1078, and it has not proven its case to our satisfaction.

The parties are agreed that the record does not show whether the Southern Pacific and San Francisco Terminal bonds were held by the Union Pacific for investment prior to the exchange in 1921, but petitioner assumes for the purpose of argument that they were so held. The petitioner further concedes that the bonds delivered and those received in the exchange 147
were property of "a like kind".

Inasmuch as the statute provides for nonrecognition of gain or loss "when property held for investment * * * is exchanged for property of like kind or use," it would seem that the concession of petitioner that the bonds exchanged were of like kind would bring the transaction within the statute. But the argument is advanced that in *Richard T. Greene, et al., Trustees,* 15 B. T. A. 401, affirmed 42 Fed. (2d) 852, and *Edson* v. *Lucas,* 40 Fed. (2d) 398, it was held that the phrase "property of a like kind or use" is not to be regarded as disjunctive

but as a conjunctive expression. Under this construction of the statute it would be necessary that the property received be of like kind *and* use to that delivered in order that gain or loss be not recognized. The *Greene* case decided by the Board does not so hold. The case involved an exchange of investment stock for Federal, State, municipal, and railway bonds which were thereafter held for investment, and we held that the phrase "or use" in the statute applies to
149 property held for investment as well as to property held for productive use in trade or business. It is true that the Circuit Court of Appeals for the Second Circuit when the case was before it on appeal stated that, "If of like 'kind' and 'use', no gain is to be recognized in the exchange under the statute." We think no one will disagree with that statement. But it is not a holding, as argued by petitioner, that the property must be of like kind *and* use to come within the non-recognition provisions. In the course of the opinion the phrase "like kind or
150 use" appears several times and nowhere is there any intimation that it is to be construed in the conjunctive. In *Edson* v. *Lucas, supra,* the Board's opinion in the *Greene* case is cited with approval and we find nothing in the opinion of the Court to sustain the view contended for by petitioner here.

No reason occurs to us, and none is suggested, why the conjunction "or" should not be construed in its ordinary sense, or wherein the purpose of the statute will be defeated by giving it such construction. As the bonds delivered and those received by the Union Pacific were admittedly of "like kind", we hold that under the

statute the respondent correctly refused to recognize any loss on the exchange.

Granting that some effect should be given to the words "or use" in the statute, we are still of the opinion that the exchange here was one on which no loss can be recognized. The bonds delivered by Union Pacific were held for investment. The Salt Lake bonds received by it were acquired, not for sale, but for the purpose of placing the Union Pacific in better position for future financing. It intended, through cancelation of the bonds and the underlying mortgage, to enhance the value of its property and thus make its future bond issues more attractive to the investing public. "To invest imports a laying out of money, or money's worth * * * by the concern itself in acquiring something of permanent use in the business". *La Belle Iron Works* v. *United States,* 256 U. S. 377. Here the Union Pacific by buying up the stock of the Salt Lake acquired operating control of the railroad, but that road was burdened with the outstanding mortgage and bonds and was of little value for financing purposes; by taking up the bonds the Union Pacific acquired it free from obligation, and this, its bankers advised it, would be most helpful in getting a good price for its bonds. Viewing the transaction in this way it seems to us that it can properly be said that the Salt Lake bonds were acquired for investment purposes in that the Union Pacific thereby acquired "something of permanent use in the business".

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The amendment to Section 202(c)(1) of the Revenue Act of 1921, made by the Act of March 4, 1923, was effective as of January 1, 1923, and

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Opinion.

does not affect the transaction here involved. *Florence G. Baldwin,* 23 B. T. A. 512.

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Issue P for 1920, 1921 and 1922; Issue H for 1923. Whether deductions are allowable for amortization of discounts and commissions on bonds issued by Union Pacific Railroad Company and Oregon Short Line Railroad Company prior to 1913.

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All of the findings of fact proposed by petitioners relating to these issues are agreed to by respondent, and we adopt them as our findings. For the purposes of this report it will be sufficient to say that prior to 1913 the two railroads sold several issues of bonds at varying rates of discount and in connection with the sales paid commissions to bankers. The railroads claim, and the respondent has refused to allow, deductions in the taxable years for the discounts and commissions amortized over the life of the bonds. The amounts claimed are summarized as follows:

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	Discount	*Commissions*
Convertible bonds	$161,011.35	$ 6,708.80
First lien and refunding bonds	5,285.20	12,143.77
Refunding bonds	85,600.00	38,400.00
Total annual deduction claimed	$251,896.55	$57,252.57

Counsel for respondent concedes that in *Chicago, Rock Island & Pacific Railroad Co.,* 13 B. T. A. 988, we have decided the question of

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amortization of bond discount adversely to him. In accordance with that decision we hold that petitioners here are entitled to the deductions claimed on account of bond discount.

The other question under these issues has been decided against the petitioners' claims in the *Chicago, Rock Island & Pacific* case, *supra*, at pages 1034, 1035, and in *Kansas City Southern Railway Co.*, 22 B. T. A. 949, 966. We have carefully considered petitioners' arguments against the propriety of the decisions cited, but we are not convinced that they are wrong and so we adhere to them in the present proceedings and hold that petitioners are not entitled to the deductions claimed on account of commissions.

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Motion for Review of Report by Full Board.

(Filed Oct. 24, 1932.)

UNITED STATES BOARD OF TAX APPEALS,

UNION PACIFIC RAILROAD COMPANY, OREGON SHORT LINE RAILROAD COMPANY, THE ST. JOSEPH AND GRAND ISLAND RAILWAY COMPANY, SAN FRANCISCO AND PORTLAND STEAMSHIP COMPANY, by Oregon-Washington Railroad & Navigation Company, successor, YAKIMA VALLEY TRANSPORTATION COMPANY, THE UNION PACIFIC COAL COMPANY, WASHINGTON UNION COAL COMPANY, OREGON AND WASHINGTON RAILROAD COMPANY, THE RATTLESNAKE CREEK WATER COMPANY, UNION PACIFIC WATER COMPANY, UNION PACIFIC EQUIPMENT ASSOCIATION, GREEN RIVER WATER WORKS COMPANY, PORTLAND TERMINAL INVESTMENT COMPANY, Petitioners, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket Nos. 35,639, to 35,649, 35,684, 35,685.

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OREGON-WASHINGTON RAILROAD & NAVIGATION COMPANY, as transferee of The San Francisco and Portland Steamship Company, Petitioner, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 40,002.

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UNION PACIFIC RAILROAD COMPANY, LOS ANGELES & SALT LAKE RAILROAD COMPANY, DES CHUTES RAILROAD COMPANY, Petitioners, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket Nos. 40,060, to 40,062.

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Now come the petitioners, by their counsel of record, and move that, in accordance with Section 601 of the Revenue Act of 1928, the Chairman of the Board direct that the report of the Division, promulgated October 7, 1932, in the above proceedings, shall be reviewed by the full Board.

In support of this motion counsel state that two of the issues in said cause are of such importance that a review by the full Board is desirable. Issue L involves approximately $500,-

166 *Motion for Review of Report by Full Board.*

000.00 taxes and relates to a loss in 1921 through the exchange of certain bonds for bonds of the Los Angeles & Salt Lake Railroad Company pursuant to a contract with the late W. A. Clark. Issue P for 1920-1922 and issue H for 1923 involve the amortization of commissions on bonds issued prior to 1913, and the amount of taxes in dispute is approximately $6,000.00 for each of the years before the Board, but this issue is also in controversy between the parties
167 for later years, some of which are pending before the Board and others are now in audit. Counsel feel that the importance of these issues suggest a review of the report promulgated herein by the entire membership of the Board of Tax Appeals, and it is hoped that the Chairman will direct such review within thirty days from October 7th, as required by law.

October 24, 1932.

HENRY W. CLARK,
HARRY J. GERRITY,
Attorneys for Petitioner.

168 Denied.

Oct. 25, 1932.

(Signed) JOHN M. STERNHAGEN,
Acting Chairman,
U. S. Board of Tax Appeals.

169

Decision.

Docket Nos. 35639 and 40060.

Counsel for petitioners have filed a proposed recomputation in the above-entitled proceedings and counsel for respondent has noted thereon that the proposal is in accordance with the opinion of the Board heretofore promulgated. Wherefore, in accordance with the petitioners' proposal, it is

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ORDERED and DECIDED that in the case of the Union Pacific Railroad Company there is a deficiency for the year 1920 in the amount of $496,768.09 and that for the years 1921, 1922 and 1923 there are overpayments in the respective amounts of $93,630.42, $34,196.92 and $58,986.52, and it is

FURTHER ORDERED and DECIDED that there is no deficiency in income or profits taxes due from, or overpayments due to, the several other petitioners above named.

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Enter.

(Signed) C. R. ARUNDELL,
Member.

Entered Dec. 3, 1932.

(Seal of Board of
Tax Appeals)

172 **Petition for Review.**

(Filed Jan. 21, 1933.)

UNITED STATES BOARD OF TAX APPEALS,

Docket Nos. 35,639 and 40,060.

UNION PACIFIC RAILROAD COMPANY,
Petitioner,
against
173 COMMISSIONER OF INTERNAL REVENUE,
Respondent.

UNION PACIFIC RAILROAD COMPANY, petitioner, is aggrieved by a decision of the United States Board of Tax Appeals rendered on the 3rd day of December, 1932, in the cases of *Union Pacific Railroad Company,* Petitioner, v. *Commissioner of Internal Revenue,* Nos. 35,639 and 40,060 on the docket of the Board, determining that there
174 is a deficiency in petitioner's Federal income tax for the year 1920 in the amount of $496,768.09 and that for the years 1921, 1922 and 1923 there are overpayments in the respective amounts of $93,630.42, $34,196.92 and $58,986.52, and respectfully submits its petition for a review thereof by the Circuit Court of Appeals for the Second Circuit.

I.

VENUE

The petitioner's income tax return for each of the years aforesaid, being consolidated re-

turns for petitioner and its affiliated companies, was filed in the office of the United States Collector of Internal Revenue for the Second New York District located in the Second Judicial Circuit.

II.

NATURE OF THE CONTROVERSY

The controversy involves the determination of petitioner's liability for Federal income taxes for the calendar years 1920, 1921, 1922 and 1923. 176

Loss on Clark Trade—1921.

Petitioner appeals from the adverse decision of the Board on the issue designated as Issue L in its amended petition to the Board in Docket Number 35,639.

Pursuant to a contract dated April 27, 1921, between petitioner and one William A. Clark, petitioner delivered to said Clark and other persons certain bonds issued by Southern Pacific Railroad Company, Southern Pacific Company 177 and Oregon Washington Railroad & Navigation Company, respectively, to an aggregate amount exceeding $29,000,000, face value, and received in exchange therefor approximately the same amount, at face value, of bonds issued by Los Angeles & Salt Lake Railroad Company. Petitioner asserts that it incurred a loss of $5,243,312.99 upon said exchange of bonds, being the difference between the cost to petitioner of the bonds so delivered by it and the market value of the bonds so acquired in exchange, subject to a small adjustment made in cash, and that it is

178 *Petition for Review.*

entitled to the deduction of said loss in the computation of its income tax liability for the year 1921 under the provisions of the Revenue Act of 1921. The Board of Tax Appeals has held that the said exchange of bonds was one on which no loss is entitled to recognition.

Amortization of Bond Commissions—1920, 1921, 1922 and 1923.

179 Petitioner appeals from so much of the decision of the Board as is adverse to it on the issue designated as Issue P in its amended petition to the Board in Docket Number 35,639 and Issue H in its amended petition in Docket Number 40,060.

Prior to 1913 petitioner and one of its affiliated companies made certain issues of corporate bonds and sold the same at a discount and incurred in connection therewith certain bankers' and underwriters' commissions. Petitioner asserts that both the discount and the commissions

180 incurred as aforesaid may be amortized over the life of the said bonds and the annual amortization deducted in the computation of petitioner's income tax liability for each of the years 1920 to 1923, inclusive, under the Revenue Acts of 1918 and 1921. The Board of Tax Appeals has allowed the annual amortization of said discount but has held that said commissions may not be amortized. The annual amortization of said commissions amounts to $57,252.57.

ASSIGNMENT OF ERRORS

The Board of Tax Appeals erred in its decision aforesaid in the following respects:

Petition for Review. 181

Loss on Clark Trade—1921.

1. In refusing to allow as a deductible loss for the year 1921 the difference between the cost to the petitioner of the bonds of Southern Pacific Railroad Company, Southern Pacific Company and Oregon-Washington Railroad & Navigation Company delivered by petitioner and the market value of the bonds of the Los Angeles & Salt Lake Railroad Company received by petitioner in exchange for said first mentioned bonds, pursuant to the contract of April 27, 1921, between petitioner and William A. Clark, and, more particularly, the following rulings as the bases of such refusal: 182

(a) In holding that said exchange of bonds was within the purpose and intent of Section 202, paragraph (c)(1), of the Revenue Act of 1921, excluding from recognition gains or losses on certain exchanges of property.

(b) In holding that the bonds of the Los Angeles & Salt Lake Railroad Company received in the exchange aforesaid were acquired for investment within the meaning of said Section 202(c)(1). 183

(c) In finding contrary to the uncontradicted evidence that the bonds of the Oregon-Washington Railroad & Navigation Company delivered in the exchange aforesaid were held by petitioner for investment and refusing to find in accordance with the uncontradicted evidence that said bonds were

184 *Petition for Review.*

held primarily for sale, both within the intent of said Section 202(c)(1).

Amortization of Bond Commissions—1920, 1921, 1922, 1923.

2. In refusing to allow as a deduction from income in each of the years 1920, 1921, 1922 and 1923 the amount of $57,252.57 as annual amortization of commissions of bankers and underwriters incurred upon issues of bonds of the
185 petitioner and one of its affiliated companies made prior to 1913.

Dated, January 18, 1933.

HENRY W. CLARK,
120 Broadway,
New York, N. Y.

HARRY J. GERRITY,
Hill Building,
186 Washington, D. C.
Counsel for Petitioner.

State of New York, }
County of New York, } ss.:

HENRY W. CLARK, being duly sworn, deposes and says: That he is a Vice-President of Union Pacific Railroad Company, the petitioner named in the foregoing petition, and is duly authorized to verify said petition; that he has read said petition and is familiar with the statements contaned therein; and that the facts stated therein are true except as to those facts stated to be

upon information and belief and those facts he believes to be true.

HENRY W. CLARK.

Sworn to before me this
18th day of January, 1933.

JOHN M. LEE,
Notary Public.
New York County No. 62.
New York Reg. No. 4L235.
Cert. filed in Nassau County.
Com. expires Mar. 30, 1934. 188

(Seal)

Statement of Evidence.

UNITED STATES BOARD OF TAX APPEALS.

UNION PACIFIC RAILROAD COMPANY, 189 against COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket Nos. 35,639 and 40,060.

(Filed Jan. 31, 1933.)

The following is a statement of evidence submitted to the Board of Tax Appeals in the above entitled case, so far as is necessary to the assignment of errors as filed, reduced to narrative form:

190 *Statement of Evidence.*

TESTIMONY OF HENRY W. CLARK

HENRY W. CLARK, called as a witness on behalf of petitioner, testified as follows:

I was General Counsel of Union Pacific in 1921.

The contract dated April 27, 1921, shown me, between William A. Clark and Union Pacific Railroad Company is a duplicate original of the
191 contract which it purports to be. I am familiar with the signatures thereto of the Chairman and Secretary of Union Pacific Railroad Company and of Senator W. A. Clark. They were all affixed in my presence and duplicate originals of the contract were exchanged in my presence.

The contract was offered in evidence and received as *"Petitioner's Exhibit No. 5"*. A copy is attached to this statement of the evidence.

192 TESTIMONY OF ROBERT S. LOVETT

ROBERT S. LOVETT, called as a witness on behalf of petitioner, testified as follows:

On Direct Examination:

I am Chairman of the Board of Directors of the Union Pacific Railroad Company and its principal subsidiaries. I was throughout 1920 and 1921, and for some years prior thereto, Chairman of the Executive Committee of the Union Pacific Railroad Company and as such its Chief Executive Officer. I am familiar with

the contract between the Union Pacific Railroad Company and Senator Clark which has just been received in evidence as petitioner's Exhibit No. 5. I personally negotiated on the part of the Union Pacific Railroad Company the trade embodied in that contract. The negotiations were conducted principally with Senator Clark, but also with his brother J. Ross Clark, located at Los Angeles operating headquarters of the property involved, and with E. D. Kenna whose wife was partly interested with Senator Clark in the 194
ownership of the securities of the company. Mr. Kenna was one of the Board of Directors of the Los Angeles & Salt Lake Railroad Company, nominated by the Clark interests.

The recitals to this contract state that one-half of the stock of the Los Angeles & Salt Lake was owned by the Oregon Short Line and all but a few shares of the remaining half of Senator Clark. The third parties who held those few remaining shares were identified with Senator Clark. During this joint ownership of the Los Angeles & Salt Lake Railroad Company one- 195
half of the Directors were nominated by the Union Pacific and Short Line interests and the other half by Senator Clark's interests, and Senator Clark was President during the whole period until he disposed of his ownership. That was true from about 1904 and continued until after the signing of the contract which has been introduced in evidence. The Union Pacific was entirely satisfied with the joint management to which I have testified. I mean it was harmonious. Of course, it was not the same as the management under sole ownership by the Union Pacific would be. As to the advantages which I

considered would accrue to the Union Pacific as sole owner which it did not enjoy as a joint owner, I could not enumerate them all but one of the first considerations would be that, if the Union Pacific owned the property entirely, it would immediately include it in its general system and the jurisdiction of its operating officers and traffic officers would be extended over it.

The President of the Union Pacific who is located at Omaha had no control over the Salt
197 Lake road. The traffic department of the Union Pacific had no control except, of course, as to certain through traffic under an understanding it could get rates to meet competition, but it had no control over traffic wholly on the Salt Lake. Train schedules could not be made or changed on the Salt Lake road by the Union Pacific Line under joint control. All of that would be changed under sole ownership and those matters would be under the control of the operating department, operating matters, and the traffic arrangements would be under the
198 traffic department of the Union Pacific, and changes in schedules and otherwise could be made at their pleasure, subject, of course, to the law. But now with the joint control no changes could be made in any of those matters without consultation with the Clark interests and in view of the very fierce competition as to all through traffic, control by the Union Pacific and the power to bring immediate action we deemed very important. I thought I made it clear or indicated that the Union Pacific operating organization, that is our President and his staff that operate the Union Pacific System had no control itself over the operations of the Salt

Lake Railroad under joint management. Under sole control, of course, they would have complete control over the Salt Lake Line just as they would have over the Union Pacific's own lines. 199

Prior to 1921 the Union Pacific had no entrance into Southern California except through its relationship with the Salt Lake Railroad. I considered at that time, or before that time, that it was to the advantage of the Union Pacific to have its own entrance into Southern California. In view of the considerations I have named the Union Pacific management, prior to 1921, wanted sole ownership of the Salt Lake Railroad. 200

I first took up with Senator Clark or anyone representing him the question of buying his half of the stock in the Salt Lake Railroad some four or five years before making the contract of 1921. I approached Senator Clark on the question of buying his interest and he answered that he would not know what to do with the money if he sold it, and we had some discussion on that difficulty. I suggested that the Union Pacific ought to have it, that he was not in the railroad business. Without going into all of the arguments here I tried to convince him that he should sell to the Union Pacific and use his money in some other way and that sole control was necessary to making the road a success with competition we had and he finally, after a good deal of hesitation said: "Well, if you really feel that the Union Pacific ought to own it, that it should be a single line, I am willing to sell, or sell my stock at par but no less". I told him if that was really his feeling about it we would not discuss 201

202 *Statement of Evidence.*

it any further and we both should forget it and the subject was not mentioned again until along in 1921. That price was entirely beyond reason. At that time we discussed only the question of buying his half of the stock. There was no discussion of buying his bonds.

In the latter part of 1920 we had some further discussion of acquiring his interest. I can't give the exact date. That conversation was with E. D. Kenna who, as I say, was interested or
203 his wife was interested in the ownership of some of the securities, stock or bonds. I do not know what their exact relations were but he was one of the associates of Senator Clark, what we called Clark directors of the Salt Lake road. He wanted to sell, he thought that Senator Clark wanted to sell. The Senator was getting very old and he thought he should sell. We discussed the value, the price to be put on the stock, or the question involved two points, the bonds, the question of the bonds as well as the stock. I also had a discussion with J. Ross Clark who
204 was part owner of the so-called Clark interest. The Senator at that time was willing to keep the bonds if the Union Pacific would guarantee them. At first I was disposed to agree to that, but I did not give it really very much consideration. The negotiations at that time resulted in inability to get together on the price of the stock.

Negotiations were resumed early in 1921, first with J. Ross Clark who was second Vice President or one of the managers connected with the management of the operations in Los Angeles, and as I say he was part owner of the Clark interests; then with Mr. Kenna and finally with

Senator Clark when I got back to New York. In these final negotiations I insisted that we wanted the bonds as well as the stock and gave my reasons as to why that was so. The main consideration was to get all of this stock and thus secure the merging of control of the company, but these bonds were first lien on practically 1,000 miles of railroad. The Union Pacific owned $29,000,000 and the Clark interests owned $29,000,000 in equal amounts and I conceived the idea that there was a good bit of money invested in them and a great deal more would be required and we wanted the bonds in order to have all of them. We could cancel them if further financing was deemed necessary; we could cancel that mortgage and cancel the bonds on all of that merged property in the Union Pacific, and when further financing became necessary as it would probably in a few years we would issue a new mortgage. This mortgage was limited to a maximum issue of $70,000,000 which left a margin outside of those owned by Senator Clark and the Union Pacific of $10,000,000, which was too small for future development of the property and that we would cancel or in lieu of that we would put on a new mortgage for the Union Pacific System. Such new bonds, secured by mortgage covering the entire Union Pacific System as a lien inferior to the outstanding bonds of the Union Pacific Lines, but would be a first lien on about 1,000 miles constituting the road we are talking about, the Los Angeles & Salt Lake, and we were advised by our bankers that a first lien on that much railroad of the Union Pacific mortgage, a first lien feature would be most helpful in getting a good price for bonds. Among

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208 *Statement of Evidence.*

the other Union Pacific lines we had at that time no mileage available as first lien mileage for any new financing, that I recall. There may have been a little branch here and there, but I recall none.

I do not know that I can summarize my purpose in acquiring the Salt Lake bonds from Senator Clark other than to state it was to acquire ownership of every bond in connection with the acquisition of the mileage secured or
209 covered by the lien of the mortgage, to get in a position to cancel those bonds and make a new and larger mortgage whenever our requirements made it necessary that would be a first lien on this mileage aggregating about 1,000 miles. We never at any time intended and never since as officers of the company contemplated the sale of these bonds, but merely holding them until such time as we should find it advisable to finance by issuing such mortgage. We did not acquire those bonds for investment or for productive use or otherwise than in the manner in which I have
210 stated.

As to reason for issuing in 1914 the bonds of the Oregon-Washington Railroad & Navigation Company which were given in exchange in this Clark trade, something over $14,000,000, which the pleadings admit were acquired by the Union Pacific in 1914: There had been discussions and proposals for some years, I do not recall how long, of legislation looking to the regulation of the issuance of securities by the Interstate Commerce Commission, and my thought was that if the company issuing the bonds sold them, even though to the parent company, that it might leave us as free as we had

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been at that time in afterwards selling the bonds, and I, for that reason, instructed counsel to arrange with the various subsidiaries that we controlled, including the O-W. R. & N., and I think the Oregon Short Line, to secure from the trustee the certification of such bonds as we might be entitled to. I do not know whether these bonds were actually in the treasury at that time or not. We then took up with the Committee or Board the question of selling the bonds to the Union Pacific, and that, of course, was the

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proceeding, the idea being to anticipate legislation which might impose very great restrictions on the issuance of securities which in those States had been free heretofore, and, largely, I might say, almost exclusively that consideration entered into the purchase of the bonds. The Union Pacific expected to hold them and sometime in the future, perhaps, to guarantee them and sell them. In the meantime I would say that the Union Pacific did not hold them for investment or for any productive use, because we owned all of the stock.

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Although these bonds were acquired by the Union Pacific from its subsidiary in 1914 they were still on hand, unsold in 1921, available for this Clark trade. From the outbreak of the European War there was practically no market for four per cent. bonds, and we had no purpose in selling them. We had other resources, and, as I say, these bonds really were not saleable because they were four per cent. bonds, except at ruinous discount.

On Cross Examination:

Senator Clark did not, so far as I know, own stock in the Union Pacific Railroad at the time

the stock and bonds of the Los Angeles & Salt Lake Railroad Company were acquired.

These bonds of the Salt Lake company were not cancelled and retired. None of them have been cancelled and retired up to the present. The Union Pacific still owns all of them. The mortgage securing these bonds has not been released but is still in effect.

The Navigation Company bonds which were exchanged for the Salt Lake Company's bonds were acquired in 1914 by the Union Pacific. I
215 don't know whether the Navigation Company paid interest on those bonds during the period they were held by the Union Pacific or whether we cancelled the coupons. I couldn't tell you that, because we regarded it as amounting to the same thing.

All of the bonds of the Navigation Company acquired in 1914 were held by the Union Pacific up until the date they were exchanged for the Salt Lake Company's bonds. Of course, previous to that, it had acquired bonds from the Navigation Company which it sold long before that.
216 But it didn't sell any of the bonds acquired in 1914.

The stock of the Salt Lake Company acquired by the Union Pacific covered all of the outstanding stock, except what the Union Pacific, through the Oregon Short Line, already owned. The Oregon Short Line was a subsidiary of the Union Pacific. And the Navigation Company was also a subsidiary of the Union Pacific through the Oregon Short Line—the Union Pacific owned 100 per cent. of the Oregon Short Line stock, and the Oregon Short Line, as I recall, owned all the stock of the Navigation Com-

pany except qualifying shares for directors on which we had options. That condition existed all of the time from 1914 up through 1921.

I don't recall whether the Union Pacific ever disposed of any of the bonds that it had acquired in the Southern Pacific Company prior to 1921. I couldn't answer as to what we did, or may not have done with respect to the Southern Pacific bonds because the companies had been separated by the courts in 1913, and the Union Pacific no longer had any control over, or interest in, the Southern Pacific; and while it held some of the bonds that it had acquired before they were separated by the courts, I could not answer as to—. Those bonds which they held were bonds that were exchanged for the Salt Lake Company's bonds. The Union Pacific, from about 1901, I think, began to acquire stock of the Southern Pacific, and it acquired practically control—that is, 46 per cent. of the capital stock of the Southern Pacific, which it held until 1913 when the Government brought suit under the anti-trust laws claiming that the control of the Southern Pacific by the Union Pacific was in violation of the anti-trust law. The Supreme Court so held in a case decided in December, 1912, and ordered the Union Pacific to discontinue and cease that control, and dispose of its stock; and pursuant to the decree of the Supreme Court we disposed of all of that stock in 1913. We owned and still own some bonds of the Southern Pacific that we had acquired when we regarded it somewhat as a subsidiary; not complete control of it, but as I say, we only owned about 46 per cent. of the outstanding stock. But we held some of those bonds. Whether

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220 *Statement of Evidence.*

we had disposed of some of them before the date of the trade with Senator Clark or not I don't remember. I know that we had the amounts stated in the contract there, on hand and unpledged, at the time of the trade with Clark. Those were a part of the bonds which had been acquired prior to the date the Southern Pacific stock was disposed of.

On Re-direct Examination:

221 These Salt Lake bonds, acquired from the Senator in 1921 have not been cancelled up to date because we have had no need to issue, or if we had need to issue, we didn't have any opportunity to make a satisfactory issue of the extensive financing that I had in mind that, some time or other, the company might have to do. We have had other resources; and, therefore, we have left these bonds as they were; knowing that, at any time, owning all of them—there may be one or two outstanding yet—all of the stock
222 of the company, and all of the bonds, that at any time we wanted to do such financing we could proceed with it by simply cancelling the mortgage and providing for a new mortgage, and cancelling the bonds.

In the meantime there has been necessity for the Union Pacific to do some financing or refinancing. In 1927, for instance, there was a maturity of Union Pacific convertible bonds. As to how that maturity was financed I haven't got the dates fixed. There were two or three small, comparatively small issues, that matured. There was one in 1922. I can't answer from memory as to these dates very well. But I think,

as to one of those issues, we probably arranged for an extension of it for some years. There was another issue of Oregon Short Line—I think it was an issue of the Oregon Short Line's bonds—refunded with that issue. I haven't looked this up—it is some years ago—but my recollection is that we made one issue of bonds of the Oregon Short Line, about 26 millions, something like that I think, of mortgage bonds of the Oregon Short Line, guaranteed by the Union Pacific. Then there was an issue of 45 millions of the 224
Oregon Short Line bonds, guaranteed by the Union Pacific—Oregon Short Line collateral bonds that matured the 1st of December in 1929, that we paid off in cash, reducing the mortgage debt that much. Some of the small issues were paid off in cash. Until recent years we have had pretty large surplus earnings from the system as a whole, from investments and otherwise, and the small issues we could sometimes pay off, or we would have other assets that we could use. But we have issued no mortgage, except this Oregon Short Line mortgage in 1926, so far as 225
I recall, since this contract with Clark was made; and we certainly have issued no system mortgage, and no mortgage covering the Los Angeles & Salt Lake Railroad. I am not sure that we have made a Short Line mortgage, or a Short Line mortgage bond issue, since 1921.

If the Navigation Company had paid interest to the Union Pacific on those Navigation bonds held by the Union Pacific between 1914 and 1921, assuming that the interest was paid, the payment would have been effected and handled by cancelling the coupons and crediting the Navigation Company in an open account on the books

226 of both the Union Pacific and of the Navigation Company itself. It would have been simply an open-account transaction.

AMENDMENT OF PLEADING.

Mr. Clark: If your honor please, while we are at this point I think I will move to amend our pleadings upon this issue in a slight respect. Paragraph 78 alleges:

227 "Said Salt Lake bonds were not acquired by said Union Pacific Railroad Company as an investment, but as a means of acquiring a one-half interest in the Salt Lake railroad theretofore owned by said Clark, and so securing the operating control of the railroads of that company."

And the last sentence of the same paragraph alleges:

228 "Said Clark was not willing to dispose of his stock interest in said Salt Lake company, without disposing of his holdings of bonds of said company, and made it also a condition of said contract that the other holders of said bonds should have the privilege of disposing of their bonds upon the same terms."

In making those allegations in the petition, in the pleadings, I thought that I was stating the facts exactly, but Judge Lovett's recollection of the matter is more accurate than mine, and necessarily so, because he was the actual negotiator. So that there is a slight variance between the allegations which I have just read and the

testimony which we have given as to the purpose of our acquiring the Salt Lake bonds.

Therefore, I move to amend the pleadings in respect of paragraph 78 of the amended petition for 1920 to 1922 by striking out the first sentence of paragraph 78 and substituting the following language:

> "Said Salt Lake bonds were not acquired by the Union Pacific Railroad Company as an investment or for productive use, but as an incident to the acquisition 230 of the stock interest in the Salt Lake company theretofore held by said Clark, and for the purpose of canceling said bonds, discharging the mortgage securing the same and making the property of the Salt Lake company available as a first lien security for new financing, either of the Salt Lake company itself or of the Union Pacific System, whenever needed in the future."

And then strike out the last sentence of that 231 paragraph which seems to be entirely inaccurate.

Mr. Algire: I have no objection to the amendment, your honor.

The Member: It will be allowed.

Mr. Algire: I would like to have the record show that the respondent's answer to the paragraph, as amended, is the same as the answer to the amended petition.

Mr. Clark: In other words a complete denial?

Mr. Algire: A complete denial of the paragraph.

Mr. Clark: That is agreeable.

232 *Statement of Evidence.*

The Member: Very well.

Mr. Clark: I offer in evidence a certified copy of the action of the Union Pacific Railroad Company's executive committee on April 19, 1921, authorizing the Chairman to proceed with the Clark trade on the terms which were embodied in the contract of April 27, 1921. This is certified, Mr. Algire, by the secretary. I suppose you do not want any further proof of it. I can prove it.

233 Mr. Algire: No objection.

The Member: It will be received.

(Said document so offered and received in evidence was marked "Petitioner's Exhibit No. 6". A copy is attached to this statement of the evidence.)

TESTIMONY OF HENRY W. CLARK.

HENRY W. CLARK, recalled as a witness on behalf of petitioner, testified as follows:

234 *On Direct Examination:*

I am offering this testimony because Judge Lovett's memory wasn't entirely accurate about the subsequent financing. In 1922 some funds were required and although I am quite sure—I know—there was not any maturity to be refunded at that time, just needed for general funds, an issue was made and sold by Kuhn, Loeb & Company of some first lien and refunding bonds of the Union Pacific Railroad Company. Those were bonds under an existing mortgage that had been in the treasury for some time; and as the original issue was a 4 per cent.

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bond, and at that time 4 per cent. bonds weren't readily salable; so we modified the mortgage by a supplemental indenture permitting the issue of additional bonds at 5 per cent., and made this mortgage bond issue 5 per cent. under the existing mortgage, as I state.

The next financing by any of the Union Pacific companies occurred in 1927. In that year there matured about 26 millions of convertible bonds, which had been issued 20 years earlier by the Union Pacific Railroad Company, and it was found possible to refund that maturity by the issuing of some 4 per cent. debentures. That is not a mortgage bond, at all, just an unsecured promise to pay by the Union Pacific Railroad Company.

236

In the following year, 1928, we had another maturity, namely, of an issue of 20 millions of 6 per cent. collateral trust notes, that had been made by the Union Pacific Railroad Company in 1918, and we were able to refund that with an issue of debentures.

I think my former statement was wrong, that the debentures we issued in 1927 were 4½ and those issued in 1928 were 4 per cent.

237

Judge Lovett mentioned another large maturity of Oregon Short Line refunding bonds that was paid off in cash.

So that the three issues I have stated are the only securities issued, other than some equipment trust notes made by the Union Pacific, since 1921.

Mr. Clark: I am not sure, Mr. Algire, that it appears anywhere in our record that, prior to this Clark deal, the Oregon Short Line Railroad Company owned half of the capital stock of the

238 *Statement of Evidence.*

Los Angeles & Salt Lake Railroad Company. We allege that in paragraph 78, but it is covered by one of your denials; so I should like to have it appear of record. Will you admit that prior to 1921 the Oregon Short Line owned half of the capital stock of the Los Angeles & Salt Lake Railroad Company?

Mr. Algire: The respondent admits that, prior to the date on which the stock and bonds of the Salt Lake company were acquired by the Union
239 Pacific from Senator Clark, Oregon Short Line Railroad Company owned one-half of the outstanding capital stock of the Salt Lake company.

The Member: That was testified to by Judge Lovett, too.

Mr. Clark: I did not think we put that in.

Mr. Algire: I do not recall whether he testified as to the stock. He testified with respect to the bonds, but I am not sure about the stock; it may be that it is in the record.

Dated, January 25, 1933.

240 HENRY W. CLARK,
HARRY J. GERRITY,
Counsel for Petitioner.

January 30, 1933.

No objection to the foregoing Statement of Evidence.

C. M. CHAREST.

Approved and ordered filed this 31st day of January, 1933.

C. ROGERS ARUNDELL,
Member.

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Petitioner's Exhibit No. 5.

AGREEMENT made this 27th day of April, 1921, between WILLIAM A. CLARK, party of the first part, and UNION PACIFIC RAILROAD COMPANY, a corporation of the State of Utah (hereinafter called "Union Pacific") party of the second part.

WHEREAS: The Los Angeles & Salt Lake Railroad Company, a corporation of the State of Utah, (hereinafter called the "Salt Lake Company"), has outstanding $25,000,000, par value, 242
of capital stock consisting of 250,000 shares of the par value of $100 each. Certificates representing 243,866 shares of said capital stock are deposited with The Farmers' Loan and Trust Company under an agreement (hereinafter called the "Stock Trust Agreement") dated June 7, 1903, as extended and supplemented by agreement dated May 1, 1915, made by and between said Clark, Edward H. Harriman (Robert S. Lovett, successor) and The Farmers' Loan and Trust Company as Trustee. Certificates represented 5080 shares of the Salt Lake Company's 243
stock are owned by and in the possession of said Clark and said Clark expects to acquire the 1054 remaining shares now outstanding. Said Stock Trust Agreement may be terminated at any time by mutual agreement of the parties thereto. Said Lovett is a party to said Stock Trust Agreement in place of Edward H. Harriman, deceased, and representing the interest of the Oregon Short Line Railroad Company in the deposited stock. The Oregon Short Line Railroad Company is a subsidiary company of the Union Pacific, all of whose capital stock is owned by

244 *Petitioner's Exhibit No. 5.*

the Union Pacific. Subject to the said Stock Trust Agreement, said Oregon Short Line Railroad Company owns 125,000 shares of the capital stock of the Salt Lake Company deposited under said Agreement and said Clark owns the remaining 118,866 of said deposited shares. The Salt Lake Company has outstanding First Mortgage Gold Bonds due in 1961 to the amount of $59,-022,000, face value, bearing 4 per cent. interest payable on January 1 and July 1. One-half of
245 said bonds, to wit, $29,511,000, face value, are owned by said Oregon Short Line Railroad Company. The remainder of said bonds are owned by said Clark and members of his family and by parties for whom said Clark desires to secure equal advantages with himself in respect of said bonds. The Union Pacific is willing to acquire the 123,946 shares of the capital stock of the Salt Lake Company owned by said Clark and the additional 1054 shares which said Clark expects to acquire as aforesaid and as an additional consideration to acquire said bonds of the Salt Lake
246 Company in exchange for other bonds as hereinafter provided.

Now, Therefore, it is agreed as follows:

1. Said Clark hereby agrees to sell, assign and transfer to the Union Pacific 125,000 shares of the capital stock of the Salt Lake Company and the Union Pacific hereby agrees to purchase said shares, at $20 per share being the total sum of $2,500,000, and upon the further consideration of the acquisition by the Union Pacific of the bonds of the Salt Lake Company, as hereinafter provided.

Petitioner's Exhibit No. 5. 247

2. To the end that the foregoing agreement may be performed the Stock Trust Agreement shall be cancelled and the shares of capital stock of the Salt Lake Company deposited thereunder released and transferred on the books of the Salt Lake Company to the beneficial owners thereof or their assignees and nominees as their several interests in said shares shall appear.

3. The performance of the foregoing agreement of sale and purchase of the shares of the capital stock of the Salt Lake Company and of 248
the agreement hereinafter contained in respect of the acquisition by the Union Pacific of the bonds of the Salt Lake Company requires the authorization by the Interstate Commerce Commission of the guaranty by the Union Pacific of Oregon-Washington Railroad & Navigation Company First & Refunding Mortgage 4 Per cent. Bonds now in its treasury and their use in accordance with the provisions of this agreement in payment or exchange for the bonds of the Salt Lake Company and the 125,000 shares of the capital stock of said Company. Immed- 249
iately upon the execution of this agreement the Union Pacific will make application to the Interstate Commerce Commission for such authority and will prosecute such application diligently. Unless such authorization shall be granted by the Commission as will in the judgment of the Union Pacific expressed through its Board of Directors, Executive Committee or Chairman, sanction the performance of this agreement in all its terms, this agreement may be terminated by the Union Pacific by written notice to said Clark of its failure to secure such authorization. Unless such authorization shall be secured within

250 *Petitioner's Exhibit No. 5.*

six months from the execution of this agreement, or such extended period as shall have been mutually agreed upon, this agreement may be terminated by either party by written notice of such termination to the other.

4. Within thirty days after the authorization by the Interstate Commerce Commission, hereinbefore mentioned, shall have been granted, said Clark will deliver to the Union Pacific at its office in New York City the certificates repre-
251 senting the aforesaid 125,000 shares of the capital stock of the Salt Lake Company, duly assigned for transfer, and at least $25,000,000, face value, of the bonds of the Salt Lake Company having attached all unmatured interest coupons appertaining thereto and, if registered, accompanied by instruments of assignment and transfer duly executed.

5. The Union Pacific will upon the delivery of stock certificates aforesaid pay to said Clark in cash the sum of $20 for each said share being
252 a total sum of $2,500,000.

6. The Union Pacific will accept all said bonds of the Salt Lake Company delivered to it by said Clark as aforesaid, whether or not in excess of the amount of $25,000,000, face value, hereinbefore agreed to be delivered by said Clark, and will deliver to said Clark in exchange therefor the following: (1) Southern Pacific Railroad Company First Refunding Mortgage 4 Per cent. Bonds to an amount at face value equal to 30 per cent. of the face value of the bonds of the Salt Lake Company so delivered; (2) Southern Pacific Company San Francisco Terminal First Mortgage 4 Per cent. Bonds to an amount at

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face value equal to 20 per cent. of the face value of the bonds of the Salt Lake Company so delivered; and (3) Oregon-Washington Railroad & Navigation Company First & Refunding Mortgage 4 Per cent. Bonds guaranteed as to principal and interest by the Union Pacific, to an amount at face value equal to 50 per cent. of the face value of the bonds of the Salt Lake Company so delivered. All bonds so delivered in exchange by the Union Pacific shall be bonds payable to bearer (or registered as to principal 254
in such names as said Clark shall request) having attached all unmatured interest coupons appertaining thereto. The interest upon the Southern Pacific Railroad Company First Refunding Mortgage 4 Per cent. Bonds and upon the Oregon-Washington Railroad & Navigation Company First & Refunding Mortgage 4 Per cent. Bonds being payable on the same dates as the interest appertaining to the bonds of the Salt Lake Company, there will be no adjustment of interest in respect of said bonds upon such exchange. The interest appertaining to the 255
Southern Pacific Company San Francisco Terminal First Mortgage 4 Per cent. Bonds is payable April 1 and October 1 of each year and in respect of the exchange of said bonds there shall be an adjustment and settlement in cash of the difference between the interest accrued in respect of said bonds and the interest accrued in respect of 20 per cent. of the face value of the bonds of the Salt Lake Company received therefor.

7. The Union Pacific agrees that, upon tender to it by said Clark, or by any other holders,

256 *Petitioner's Exhibit No. 5.*

of additional amounts of said bonds of the Salt Lake Company for exchange upon the same basis and terms provided in the foregoing paragraph 6, the Union Pacific will make such exchange upon said basis and terms; provided that said additional bonds be so tendered within three months after the date of the original delivery of stock certificates and bonds provided for in the foregoing paragraph 4 or within a further period of three months if such extension shall in any
257 case be requested by said Clark.

8. The provisions as to exchange of bonds in the foregoing paragraphs 6 and 7 are subject to the following qualifications: The Southern Pacific Railroad Company First Refunding Mortgage 4 Per cent. Bonds are not issued in denominations of less than $500, face value. It is understood that the present holdings of bonds of the Salt Lake Company are such that, if all holders presented their entire holdings of said bonds for exchange on the basis provided in the foregoing paragraph numbered 6, said exchange
258 would involve 64 fractional amounts less than $500 of said Southern Pacific Railroad Company First Refunding Mortgage 4 Per cent. Bonds. Therefore the Union Pacific will settle for all fractions less than $500 in amount, face value, of said Southern Pacific Railroad Company First Refunding Mortgage 4 Per cent. Bonds, deliverable on the basis of exchange hereinbefore provided, in cash for the face value of said fractions and the accrued interest thereon; but no settlement for such fractions will be made except with those who are holders of said bonds of the Salt Lake Company on the date of this agreement or except for such fractions

as would result from the exchange of the entire number of such bonds held by them respectively on the date of this agreement.

9. Said Clark agrees that the Demand Notes of the Salt Lake Company held by himself and members of his family, now amounting to $1,548,930, face value, will not be presented for payment unless so requested by the Union Pacific prior to March 1st, 1922, and that any additional notes of said Salt Lake Company issued pending the performance of this agreement and held by 260
said Clark or members of his family and payable by their terms prior to the date aforesaid will not be presented for payment prior to said date unless so requested by the Union Pacific; provided in both cases that the interest currently maturing upon all such notes shall be duly paid.

10. The foregoing agreement of sale and purchase in respect of said 125,000 shares of stock and $25,000,000 face value, of said bonds of the Salt Lake Company is indivisible. The Union Pacific assumes no obligation to acquire said 261
stock without said bonds or to acquire less than the above stated amounts of either said stock or said bonds. Said Clark assumes no obligation to perform the foregoing agreement in part only, but is obligated to deliver said stock or said bonds only upon the performance by the Union Pacific of its foregoing agreement to acquire both said stock and said bonds.

11. All rights and obligations under this agreement shall inure to and be binding upon the executors or administrators of said Clark and the successors of said Union Pacific.

262 *Petitioner's Exhibit No. 6.*

IN WITNESS WHEREOF the above-named parties have executed this agreement the day and year above stated.

W. A. CLARK.

UNION PACIFIC RAILROAD COMPANY,

(Seal) By ROBERT S. LOVETT,

Attest: Chairman.

THOMAS PRICE,
Secretary.

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Petitioner's Exhibit No. 6.

Extract from Minutes of Regular Meeting of Executive Committee Union Pacific Railroad Company, April 19, 1921.

PURCHASE OF STOCK OF LOS ANGELES & SALT LAKE RAILROAD COMPANY.

The Chairman reported that negotiations for the acquisition of the stock of the Los Angeles & Salt Lake Railroad Company owned by W. A. Clark and his associates had so far progressed
264 that it was apparent that all said stock, with the possible exception of 1055 shares, could be acquired upon the terms hereinafter stated. Thereupon, it was unanimously

RESOLVED that the Chairman is directed to continue his negotiations and is authorized to acquire the 125,000 shares of the capital stock of the Los Angeles & Salt Lake Railroad Company, constituting all of the said capital stock other than that of which the Oregon Short Line Railroad Company is the beneficial owner, at the price of $20 per share, and upon the further consideration of the acquisition by this Company of any or all of the outstanding bonds of the

Petitioner's Exhibit No. 6. 265

Los Angeles & Salt Lake Railroad Company other than such bonds owned by the Oregon Short Line Railroad Company in exchange, dollar for dollar, for the following bonds now in the treasury of this Company, viz: (1) Southern Pacific Railway Company First Refunding Mortgage 4 Per cent. Bonds, (2) Southern Pacific Company San Francisco Terminal First Mortgage 4 Per cent. Bonds and (3) Oregon-Washington Railroad & Navigation Company First & Refunding Mortgage 4 Per cent. Bonds, guaranteed as to principal and interest by this 266
Company, in the proportion of 30, 20 and 50 per cent. of said several issues, respectively, and upon such terms in other respects as the Chairman shall in his discretion approve; and the Chairman is further authorized, in his judgment, in case of delay in securing the 1055 shares not now controlled by said W. A. Clark to consummate said transaction on the basis of 123,945 shares upon the same terms aforesaid.

I, Thomas Price, Secretary of Union Pacific Railroad Company, do hereby certify that the 267
above and foregoing is a true copy of an extract from the minutes of a regular meeting of the Executive Committee of the Union Pacific Railroad Company duly held at the principal office of the company in the City and State of New York on the 19th day of April, 1921, at which a quorum was present.

In Witness Whereof, I have hereunto subscribed my name and affixed the seal of said Company this 27th day of November, 1931.

Thomas Price,
Secretary.

(Seal)

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Praecipe.

UNITED STATES BOARD OF TAX APPEALS.

(Filed January 2, 1933.)

Docket Nos. 35,639 and 40,060.

UNION PACIFIC RAILROAD COMPANY, Petitioner,	
against	
COMMISSIONER OF INTERNAL REVENUE, Respondent.	

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TO THE CLERK OF THE UNITED STATES BOARD OF TAX APPEALS:

You are hereby requested to prepare and certify and transmit to the Clerk of the United States Circuit Court of Appeals for the Second Circuit as the record on petition for review heretofore filed by the petitioner in the above entitled cases the following:

270

1. The docket entries of all proceedings before the Board of Tax Appeals in the above entitled cases.

2. The Amended petition in Nos. 35,639 *et seq.*, covering the years 1920 to 1922.

3. The amended petition in Nos. 40,060 *et seq.*, covering the year 1923.

4. Respondent's answer to the amended petition in Nos. 35,639 *et seq.*

Praecipe.

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5. Respondent's answer to the amended petition in Nos. 40,060 *et seq.*

6. Order consolidating said cases for hearing.

7. Opinion of the Board of Tax Appeals.

8. The petitioner's motion for a review of the decision by the full Board and the denial thereof.

9. The order of redetermination of the Board of Tax Appeals entered December 3, 1932.

10. Petition for review of the Board of Tax Appeals decision by the United States Circuit Court of Appeals.

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11. The statement of evidence with petitioner's Exhibits 5 and 6 attached thereto, when the same shall have been settled by the Board.

12. This Praecipe.

Dated January 27, 1933.

HENRY W. CLARK,
HARRY J. GERRITY,
Counsel for Petitioner.

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Clerk's Certificate.

UNITED STATES BOARD OF TAX APPEALS,

WASHINGTON.

UNION PACIFIC RAILROAD COMPANY, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket Nos. 35639 and 40060.

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I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 270, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of records in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

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In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 10th day of March, 1933.

B. D. GAMBLE,
Clerk,
United States Board of Tax Appeals.

(Seal)

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Stipulation and Order Omitting Certain Matter from Record.

UNITED STATES CIRCUIT COURT OF APPEALS,

FOR THE SECOND CIRCUIT.

UNION PACIFIC RAILROAD COMPANY,
Petitioner,
against
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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IT IS HEREBY STIPULATED AND AGREED by and between the parties hereto that of the documents referred to below, copies of which are contained in the record filed herein, only the parts indicated below shall be printed.

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Amended Petition in Docket No. 35,639 of the Board of Tax Appeals, Income Taxes for 1920, 1921, 1922: The caption, excluding all docket numbers except 35,639, and the succeeding matter to the end of Part III. Of Part IV, the heading "IV". Assignment of Errors", the paragraph immediately following said heading, and the paragraphs designated by the letters L and P respectively. Of Part V, the heading "V. Facts" and the succeeding matter to but not including the caption "A—Apportionment of Consolidated Tax"; the caption "L—Loss on Clark Trade—1921" and the succeeding matter to and

280 *Stipulation and Order Omitting Certain Matter from Record.*

including paragraph numbered 82; the caption "P—Prior-to-1913 Bond Discount—1920, 1921, 1922" and the succeeding matter to and including paragraph numbered 121. Of Part VI, only its caption and introductory paragraph. The final paragraph of said Amended Petition, the date and signatures. Neither the verification nor the exhibits shall be printed.

281 *Answer to Amended Petition in said Docket No. 35,639*: The above docket number. The matter following the caption (which, except said docket number, is not to be printed) to the end of Part III. Of Part IV, the number "IV" and the paragraph designated by the letters K to P. Of Part V, the number "V", the heading *"General Allegation"*, the paragraph numbered 1, 2, 3 and 4, the caption "L—Loss on Clark Trade—1921", paragraphs numbered 71 to 82 inclusive, the caption "P—Prior to 1913 Bond Discount—1920, 1921, 1922", and the paragraph numbered
282 99 to 121. The final paragraph of said Answer, and the signature.

Amendment to Answer to Amended Petition in said Docket No. 35,639 is not to be printed.

Reply in said Docket No. 35,639 is not to be printed.

Amended Petition in Docket No. 40,060 of the Board of Tax Appeals, 1923 Income Taxes: The caption, excluding all docket numbers except 40,060, and the succeeding matter to the end of Part III. Of Part IV, the heading "IV. Assignment of Errors", the paragraph immediately following said heading and the paragraph desig-

Stipulation and Order Omitting Certain Matter from Record. 283

nated by the letter H. Of Part V, the heading "V. Facts" and the succeeding matter to but not including the caption "A—Apportionment of Consolidated Tax"; the caption "H—Prior-to-1913 Bond Discount" and the succeeding matter to and including paragraph numbered 63. Of Part VI only the caption and introductory paragraph. The final paragraph of said Amended Petition, the date and signature. Neither the verification nor the exhibits shall be printed. 284

Answer to Amended Petition in said Docket No. 40,060: The above docket number. The matter following the caption (which, except said docket number, is not to be printed) to the end of Part III Of Part IV, the number "IV" and the paragraph designated by the letters E to H. Of Part V, the number "V", the paragraph numbered 1, 2, 3 and 4, the caption "H—Prior-to-1913 Bond Discount" and the paragraph numbered 43 to 63. The final paragraph of said Answer, and the signature. 285

Amendment to Answer to Amended Petition in said Docket No. 40,060 is not to be printed.

Opinion of the Board of Tax Appeals in said Dockets Nos. 35,639 and 40,060. The above docket numbers. (The caption, except said docket numbers, is not to be printed.) The two paragraphs of the head notes entitled respectively "*Loss: Exchange of bonds for bonds*" and "*Amortization of discount and commissions on bonds issued prior to 1913.*" The heading "OPINION". The word and punctuation "ARUNDELL": and the

286 *Stipulation and Order Omitting Certain Matter from Record.*

three succeeding paragraphs. The heading beginning "Issue L" and all succeeding matter to but not including the heading beginning "Issue M for 1921 and 1922". The heading beginning "Issue P for 1920, 1921 and 1922" and all succeeding matter to but not including the heading beginning "Issue S".

Dated, April 5, 1933.

287 HENRY W. CLARK,
Attorney for Petitioner.

C. M. CHAREST,
Attorney for Respondent.

So ordered:

MANTON,
C. J.

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UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

UNION PACIFIC RAILROAD COMPANY

v.

COMMISSIONER OF INTERNAL REVENUE

Order of substitution

Upon motion of Guy T. Helvering, Commissioner of Internal Revenue, expressly consented to by the respondent, it is hereby ordered that said Guy T. Helvering, as such officer, be and he hereby is substituted for David Burnet, former Commissioner of Internal Revenue, and that this proceeding be so continued and maintained.

WM. PARKIN, *Clerk.*

Dated July 15, 1933.

United States Circuit Court of Appeals for the Second Circuit

No. 7—October term, 1933

UNION PACIFIC RAILROAD COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Argued December 18, 1933. Decided February 13, 1934

Appeal from the United States Board of Tax Appeals

Before L. Hand, Swan, and Augustus N. Hand, circuit Judges.

Union Pacific Railroad Company petitions for review of an order of the Board of Tax Appeals determining income tax liabilities for the years 1920 to 1923, inclusive. Reversed in part and remanded.

For opinion below, see 26 B.T.A. 1126.

Henry W. Clark, of New York City, for petitioner.

Sewall Key and Morton K. Rothschild, Sp. Assts. to Atty. Gen., for respondent.

SWAN, *Circuit Judge.*

The proceedings before the Board involved numerous controverted issues, of which only two have survived for review by this court. These two issues are entirely distinct. The one first to be considered relates to the taxpayer's claimed deduction of a loss incurred upon an exchange of bonds in the year 1921. The deduction was disallowed by the Commissioner and by the Board. The amount of the tax involved is more than five hundred thousand dollars.

Prior to the exchange of bonds hereafter to be described, the petitioner (for convenience referred to as Union Pacific) owned all the capital stock of Oregon Short Line Railroad Company, which in turn owned (1) all the capital stock of Oregon-Washington Railroad & Navigation Company (referred to as Navigation), and (2) one half the capital stock and one half the outstanding bonds of Los Angeles & Salt Lake Railroad Company (referred to as Salt Lake). The other half of Salt Lake stock and bonds was owned by Senator William A. Clark and members of his family. Under date of April 27, 1921, Union Pacific contracted with Senator Clark to buy at $20 per share the Salt Lake stock owned by him and his family and to exchange for Salt Lake bonds certain bonds owned by Union Pacific namely, Navigation bonds, Southern Pacific Railroad bonds, and San Francisco Terminal bonds. The cost to Union Pacific of the bonds it gave was $26,000,000, in round figures, and the market value of the Salt Lake bonds received in exchange was about $21,000,000. The difference, namely, $5,243,312.99, the petitioner claims as a loss deductible from gross income for 1921; while the Commissioner contends that the Board held, that no loss can be recognized because of section 202 (c) (1) of the Revenue Act of 1921 (42 Stat. 229, 230). This section reads as follows:

" (c) For the purposes of this title, on an exchange of property, real, personal, or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

" (1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use."

The dispute is whether, within the meaning of this statute, the bonds which Union Pacific disposed of were " property held for investment " and whether the Salt Lake bonds received in exchange were " property of a like kind or use." The Board found that the bonds given were held for investment and the bonds received were acquired for investment. These findings, the petitioner urges, are wholly without support in the evidence.

It is admitted that the Southern Pacific bonds and the Terminal bonds were held for investment, but it is contended that the Navigation bonds were " held primarily for sale." They were acquired by Union Pacific in 1914 from its wholly owned subsidiary, Oregon Short Line, having been issued in that year to anticipate possible State legislation which might impose burdensome restrictions on the issuance of securities. Union Pacific contemplated selling them at some future time, perhaps adding its own guaranty. From the time of their acquisition there was no satisfactory market for 4 per cent bonds, and, as Union Pacific had other resources, it continued to hold them until the time of the exchange in 1921. The Board held

that the petitioner had the burden of proving that the Navigation bonds were not held by it for investment, and that the foregoing facts were insufficient to so prove.

In making its contract with Senator Clark, Union Pacific had two objects in view. It desired to obtain exclusive operation control of the Salt Lake Railroad, and it desired to better its position for future financing when needed. By acquiring one half of the outstanding Salt Lake bonds, the remaining bonds being owned by Oregon Short Line, its subsidiary, it would be able at any time in the future when new financing was desirable to cancel the entire Salt Lake bond issue and thus have 1,000 miles of railroad available for a new first lien mortgage. It was never contemplated that the Salt Lake bonds would be sold, and they were still on hand at the time of the hearing before the Board in December 1931.

We think the Board was clearly correct in holding that the Salt Lake bonds were acquired for investment. Although one object in getting them was to be able to float a larger first mortgage should occasion arise, there was no refinancing plan on foot, and no one could foretell when the time would arrive. For ten years at least it did not. Meanwhile, the bonds were producing income, and the fact that they would produce income while held could not have been utterly ignored in acquiring them; the possible prospective purpose does not cancel the immediate and actual one. Property had been exchanged for income-producing bonds which were to be held for an indefinite period. This was an investment in the ordinary sense. It involved "a conversion of wealth from one form into another suitable for employment in the making of the hoped-for gains." *La Belle Iron Works* v. *United States*, 256 U.S. 377, 388, 41 S.Ct. 528, 530, 65 L.Ed. 998. Moreover, the acquisition of the bonds was inextricably tied to the acquistion of the Salt Lake stock under the April contract. That such purchase of stock was an investment could scarcely be questioned; and it would be difficult to ascribe a different character to purchase of the bonds under the same contract. If one bought income-producing improved real estate, it would hardly be argued that he made an investment in the land but not in the improvements, because he intended at some unknown future date to tear them down.

Since the Salt Lake bonds were acquired for investment, no loss can be "recognized" as resulting from the transaction insofar as they were exchanged for Southern Pacific and Terminal bonds, admittedly held for investment. Insofar as they were exchanged for Navigation bonds, the question is whether the latter were held for investment.

They were issued against the chance that legislation would impede issuing them later; Union Pacific wanted them ready to sell. But they had been held for 7 years without sale, and no one knows how long they might have been held had not the opportunity arisen to make this exchange. If one not a dealer in securities buys income-producing bonds for the purpose of sale at some unknown future time

when a favorable price can be realized or the owner's need for cash may require, it seems to us that in the common acceptation of the word he makes an "investment", and the bonds are "property held for investment" within the meaning of the statute. The parenthetical clause of the section under consideration, which contains the phrase "property held primarily for sale", refers, in our opinion, only to the words immediately preceding the parenthesis, that is, property held "for productive use in trade or business." This construction is not only more consistent with the punctuation of the paragraph, there being a comma after the word "investment" and at the end of the parenthesis, but it also finds corroboration in the form of the 1923 amendment of section 202 (c) (1), 42 Stat. 1560, which expands the parenthesis as shown below:

"(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale, and in the case of property held for investment not including stock, bonds * * * or evidences of indebtedness or interest), is exchanged for property of a like kind or use."

The modification of this phraseology in the Revenue Act 1924, § 203 (b) (1), 43 Stat. 256, 26 U.S.C.A., § 934 (b) (1), does not we think, materially weaken the argument for this construction.

It is urged that the bonds of a wholly owned subsidiary are never held by the parent company for investment; that the holding of such bonds gives the parent company no investment which it would not otherwise have because the stock ownership of the subsidiary assures the parent realization of any net income of the subsidiary, and it is immaterial whether such income is realized by way of dividends or of interest on the bonds. The testimony was that, if interest was paid on the Navigation bonds, the payment would be evidenced simply by an entry in the open account between the companies. We cannot accede to this argument. When money of the parent corporation is loaned to the subsidiary in return for its obligation evidenced by bonds, the corporations are intended to be treated as distinct legal entities; the stock ownership of the subsidiary is immaterial. Within the meaning of the section under consideration, the purchase of bonds or stock of a subsidiary is an "investment" as much as would be a similar purchase of bonds or stock of any unrelated corporation. We conclude, therefore, that the Navigation bonds were held by Union Pacific for investment; hence no loss can be "recognized" on the exchange.

The foregoing conclusions make it unnecessary to consider the petitioner's argument that the phrase "like kind or use" is to be read conjunctively as "like kind and use."

In approving the decision of the Board as to the first issue raised by this appeal we are not unmindful of the unfortunate situation in which the petitioner was placed by virtue of the retroactive feature of the Revenue Act of 1921. Had the transaction occurred earlier than 1921, there is no doubt that the petitioner would have sus-

tained a deductible loss, for the prior taxing acts contained no provision corresponding to the above-quoted section 202 (c) (1). Had the exchange been made subsequent to 1922, the loss would likewise have been deductible, for by the amendment already referred to the section was soon made inapplicable to an exchange of bonds. It is only because the Revenue Act of 1921, approved in November of that year, was made retroactive to January 1st, that the present dispute exists. Had the statute been enacted before the contract of April 27th was made, the transaction could easily have been so arranged that no question as to deducting the loss would have arisen. These considerations may elicit sympathy for the taxpayer, but they cannot be treated as relevant to a construction of the statutory language upon which decision of the controversy must hinge.

The second issue relates to the deduction in each of the taxable years under review of amortization of commissions on sales of bonds prior to 1913. Before 1909 Union Pacific and its subsidiary Oregon Short Line sold several issues of bonds at a discount and paid commissions to bankers for making or underwriting the sales. In the taxable years under review deductions were claimed for these discounts and commissions amortized over the life of the bonds. The Board of Tax Appeals allowed the deductions claimed on account of bond discount, but disallowed the deductions claimed on account of commissions. The latter amount to approximately $57,000 in each of the four years in question.

The petitioner argues with persuasive force that commissions should be dealt with on the same basis as discount; that it is immaterial whether corporate bonds are sold at a 4-percent discount, with a 2-percent commission paid to the bankers for selling or underwriting services, or are marketed at a 6-percent discount, with no payment of commission. In either case the corporation receives but $94 for each $100 which it promises to repay at maturity of the bond, and, when payment is made, a loss of $6 will be sustained; or, if incurring the obligation is considered as a realization of the loss, it will be sustained when the bond is issued. But to charge the whole loss to the business of the single year, either of issue or of payment, is contrary to recognized accounting practice and unfairly distorts the income for that year. Hence the accepted practice is to amortize it over the life of the bond.

The taxing authorities recognized this practice at an early date. In regulations 33 (revised), article 150 provided as follows:

"Art. 150: In cases wherein a corporation sells its bonds at a discount plus a commission for selling, the amount of such discount and commission, together with other expenses incidental to issuing the bonds, constitute a loss, the aggregate amount of which loss will for the purpose of an income tax return, be prorated over the life of the bonds sold, and the amount thus apportioned to each year will be deductible from the gross income of each year until the bonds shall have been redeemed."

Regulations 45, art. 544, and regulations 62, art. 545, relating respectively to the 1918 act and the 1921 act, contain a similar provision as to amortizing bond discount but omit any express reference to amortizing commissions or other expenses incidental to issuing the bonds. The practice of the Bureau, however, does not distinguish between discount and commissions and expenses with respect to bonds issued subsequent to 1913. 4 C.B. 276; 4 C.B. 129; I–2 C.B. 91; IV–1 C.B. 145; III–2 C.B. 245. In *Western Maryland Ry. Co.* v. *Commissioner of Internal Revenue*, 33 F. (2d) 695 (C.C.A. 4), it was held that the deduction in current tax years of amortization of bond discount must be recognized as well when the bonds were sold before the enactment of the income tax laws as when sold after. The Board had held the same in the *Chicago, Rock Island & Pac. R.R. Co.* v. *Commissioner of Internal Revenue*, 13 B.T.A. 988, 1027. There it was also held that expenses incurred in issuing bonds subsequent to 1913 should be amortized and deducted (page 1035), but that no such deductions could be allowed for incidental expenses with respect to bonds issued prior to 1913 (page 1034). This was affirmed in *Chicago R. I. & P. Ry. Co.* v. *Com'r*, 47 F. (2d) 990, 991 (C.C.A. 7). The precise nature of the expenses and whether they included commissions does not appear. The reason given by the Board for this distinction is stated at page 1035 of 13 B.T.A.:

"* * * We are of opinion that since the Circuit Court of Appeals [26 F. (2d) 408] has held in the *Old Colony Railroad Co. Case* [6 B.T.A. 1025], *supra*, that premiums actually received prior to March 1, 1913, are not taxable income, by the same token, expenses actually paid prior to said date are not deductible from gross income of taxable years."

It is not easy to select the precise provision of the statute which authorizes amortization and deduction either of bond discount or bond commissions. The petitioner has not attempted to pin its flag to a single specific phrase. Section 234 is the relevant section in both the Revenue Act of 1918 (40 Stat. 1077) and the Revenue Act of 1921 (42 Stat. 254). Separate paragraphs authorize the deduction from gross income of "ordinary and necessary expenses paid or incurred during the taxable year", of "interest paid or accrued", of "losses sustained" and of depreciation and exhaustion. Bond discount and commissions scarcely fall within the first category; they represent the cost of acquiring new capital, rather than an ordinary and necessary expense in carying on business during the year. Discount is often referred to as deferred interest, and deduction of amortized discount has been allowed under the "interest" paragraph. See *Western Maryland case*, *supra*. To us the "loss sustained" paragraph seems the more appropriate. Viewing discount and commissions as the cost of acquiring new capital, the loss is actually sustained when the bonds are paid or redeemed; but, since the use of the capital is extended over the life of the bonds, the income for any current year will be more fairly reflected by

prorating the loss over the period of such use. So the regulations provide, and, since the loss is really suffered when the bond is paid, that is, at a time when an income-tax law is in effect and hence at a time when the taxing officials may require the loss to be spread so as truly to reflect annual income, it is immaterial that the bonds were issued before the income-tax amendment. The analogies of depreciation deductions are persuasive. Rent or insurance paid in advance prior to 1913, or the purchase price of a wasting capital asset, such as a patent, would certainly be prorated over the years affected. See O.D. 720; 3 C.B. 145; T.D. 3414; reg. 45, arts. 163, 165, 168. A broker's commission for finding a tenant is required to be spread over the life of the lease on the theory that it is a cost of acquiring a wasting asset. See *Bonwit Teller & Co.* v. *Com'r*, 53 F (2d) 381, 384, 82 A.L.R. 325 (C.C.A. 2). The commission there involved was paid after the income-tax laws were effective, but the theory would be equally applicable had it been paid prior to 1913. It is true that in these analogous cases, the payment has resulted in acquiring an asset which year by year is exhausted; while in issuing bonds no wasting asset is acquired—rather, a liability has been incurred which upon maturity will result in loss. Concededly that loss must be spread so far as it represents bond discount. We see no reason why the other element of that loss, bond commissions, should not be treated in the same way. Premiums on bonds issued prior to 1913 cannot be spread over the life of the bonds to enhance income. *Old Colony R.R. Co.* v. *Com'r*, 284 U.S. 552, 52 S.Ct. 211, 76 L.Ed. 484. This is because the premium was received prior to the sixteenth amendment and could not be affected by a subsequent taxing act; hence the amortization requirement of the Treasury Regulations were ineffective to declare it income for subsequent years. As applied to discount, the regulations raise no constitutional question; the loss is actually sustained after the sixteenth amendment became effective, and a requirement that it be amortized for purposes of deduction from gross income is entirely valid. Similarly as to commissions, which like discount are paid out of the new capital acquired by the issuance of bonds and do not result in actual loss until the bonds are paid.

Accordingly, the decision as to bond commissions is reversed, and the cause is remanded to the Board of Tax Appeals for further proceedings in harmony with this opinion.

United States Circuit Court of Appeals, Second Circuit

At a stated term of the United States Circuit Court of Appeals, in and for the Second Circuit, held at the court rooms in the Post-Office Building in the city of New York, on the 20th day of February one thousand nine hundred and thirty-four.

Present: Hon. Learned Hand, Hon. Thomas W. Swan, Hon. Augustus N. Hand, circuit judges.

UNION PACIFIC RAILROAD COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appeal from the United States Board of Tax Appeals

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged and decreed that the order of said United States Board of Tax Appeals be and it hereby is reversed as to bond commissions and cause remanded for further proceedings in accordance with the opinion of this court.

It is further ordered that a mandate issue to the said Board in accordance with this decree.

WM. PARKIN, *Clerk.*

United States Circuit Court of Appeals, Second Circuit

UNION PACIFIC RAILROAD COMPANY

v.

COMMISSIONER OF INTERNAL REVENUE

Order for mandate

United States Circuit Court of Appeals, Second Circuit. Filed Feb. 20, 1934. William Parkin, clerk.

United States Circuit Court of Appeals for the Second Circuit

Petition filed February 28, 1934. Decided March 7, 1934

UNION PACIFIC RAILROAD COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Before L. Hand, Swan, and Augustus N. Hand, circuit judges.

On petition for rehearing

Henry W. Clark, of New York City, for petitioner.

PER CURIAM.

The taxpayer has petitioned for a rehearing as to the deduction of a loss incurred on the exchange of Navigation Company bonds in 1921. The Board held that the petitioner had not sustained the burden of proof that the Navigation Company bonds were held for investment. The petitioner complains that our opinion goes beyond an affirmance of this finding as to burden of proof and makes an

affirmative finding of fact that the Navigation bonds were held for investment. Our discussion of this subject closed with the sentence: "We conclude, therefore, that the Navigation bonds were held by Union Pacific for investment; hence no loss can be 'recognized' on the exchange." It was not our purpose to make any modification in the fact findings of the Board. Consequently our opinion will be modified by deleting the above-quoted sentence and substituting therefor the following: "We conclude, therefore, that the Board correctly held that the petitioner had not sustained the burden of proving that the Navigation bonds were not held by it for investment, hence no loss can be 'recognized' on the exchange."

The petition for rehearing is denied.

United States Circuit Court of Appeals, Second Circuit

At a stated term of the United States Circuit Court of Appeals, in and for the Second Circuit, held at the court rooms in the Post Office Building in the city of New York, on the 14th day of March, one thousand nine hundred and thirty-four.

Present: Hon. Learned Hand, Hon. Thomas W. Swan, Hon. Augustus N. Hand, circuit judges.

UNION PACIFIC RAILROAD COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

A petition for a rehearing having been filed herein by counsel for the petitioner, upon consideration thereof it is ordered that said petition be and hereby it denied.

WM. PARKIN, *Clerk.*

United States Circuit Court of Appeals, Second Circuit

UNION PACIFIC RAILROAD COMPANY

v.

COMMISSIONER OF INTERNAL REVENUE

order

United States Circuit Court of Appeals, Second Circuit. Filed Mar. 14, 1934. William Parkin, clerk.

UNITED STATES OF AMERICA

Southern District of New York

I, William Parkin, clerk of the United States Circuit Court of Appeals for the Second Circuit, do hereby certify that the foregoing pages, numbered from 1 to 130, inclusive, contain a true and

complete transcript of the record and proceedings had in said court, in the case of *Union Pacific Railroad Company, petitioner*, against *Commissioner of Internal Revenue, respondent*, as the same remain of record and on file in my office.

In testimony whereof, I have caused the seal of the said court to be hereunto affixed, at the city of New York, in the Southern District of New York, in the Second Circuit, this 7th day of April, in the year of our Lord one thousand nine hundred and thirty-four, and of the independence of the said United States the one hundred and fifty-eighth.

[SEAL.] WM. PARKIN, *Clerk.*

U. S. GOVERNMENT PRINTING OFFICE: 1934

Order allowing certiorari

Filed October 8, 1934

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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In the Supreme Court of the United States

OCTOBER TERM, 1933

No. ——

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

UNION PACIFIC RAILROAD COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Second Circuit entered in the above cause on February 20, 1934, affirming in part and reversing in part a decision of the Board of Tax Appeals. This petition is intended to be limited to the single question stated below.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 41) is reported in 26 B.T.A. 1126. The opinion of the Circuit Court of Appeals (R. 97) is reported in 69 F. (2d) 67. The part of the opinion of the Board of Tax Appeals dealing with the question here sought to

be reviewed commences at R. 52 and that of the Circuit Court of Appeals at R. 101.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 20, 1934 (R. 103). A petition of the taxpayer for rehearing was denied March 14, 1934 (R. 104–105). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer kept its books on the accrual basis, and it and the Oregon Short Line Railroad Company made consolidated returns. The taxpayer and the Oregon Short Line had both marketed issues of bonds prior to 1913, and in that connection had incurred and paid commissions to bankers. May the current year's proportion of the amortization of these commissions be subtracted in determining taxable net income in 1920, 1921, 1922, and 1923?

STATUTES AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*, pp. 9–10.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 52) may be summarized as follows:

Prior to 1913 the Union Pacific Railroad Company and its subsidiary, the Oregon Short Line, sold three issues of bonds at varying rates of discount, and in connection with the sales paid commissions to bankers. The railroads claimed deductions in the taxable years

1920, 1921, 1922, and 1923 for these discounts and commissions, amortized over the life of the bonds. The aggregate amount of the deductions claimed each year on account of discounts was $251,896.55, and on account of commissions, $57,252.57 (R. 52). The issues of bonds, the commissions paid, and the amortization of commissions, as shown by the petition to the Board of Tax Appeals, the allegations of which on this point were admitted by the answer (R. 41), were as follows:

In 1904 the Oregon Short Line sold an issue of Refunding bonds maturing on December 1, 1929, upon which it paid commissions amounting to $960,000.00, which, amortized over the twenty-five-year life of the bonds, gives $38,400.00 as the yearly amortization of commissions (R. 23, 24, 52).

In 1907 the Union Pacific sold an issue of Twenty-Year Convertible bonds upon which it paid commissions amounting to $134,176.00, which, amortized over the twenty-year life of the bonds, gives $6,708.80 as the yearly amortization of the commissions (R. 19, 20, 52).

In 1908 the Union Pacific sold an issue of First Lien and Refunding bonds maturing in 2008, upon which it paid commissions amounting to $1,214,377.16, which, amortized over the one-hundred-year life of the bonds, gives $12,143.77 as the yearly amortization of the commissions (R. 21, 52).

The Board of Tax Appeals decided that the taxpayer was entitled to the deductions claimed on account of bond discount, but not on account of

commissions. (R. 52–53.) As to the commissions, the taxpayer appealed to the Circuit Court of Appeals, which reversed the Board of Tax Appeals. (R. 101–103.)

SPECIFICATION OF ERRORS TO BE URGED

1. The Circuit Court of Appeals erred in holding that the taxpayer could deduct the amortized commissions on bonds issued prior to 1913.

2. The Circuit Court of Appeals erred in holding that the commissions paid on bonds issued prior to 1913 are losses within the meaning of Section 234 (a) (4) of the Revenue Acts of 1918 and 1921, that they will not be suffered until the bonds mature, and that they may be amortized over the life of the bonds.

3. The Circuit Court of Appeals erred in reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision below is in conflict with the decision of the Circuit Court of Appeals for the Seventh Circuit in *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990, certiorari denied, 284 U.S. 618. In that case, the taxpayer sold, prior to 1913, bonds maturing in 1934. The expenses of selling the bonds, which amounted to about $250,000, were charged to profit and loss on the dates of sale. The taxpayer claimed a prorated expense deduction for the years 1916 to 1919, inclusive, for the cost of issuing and selling the bonds, but the court held that the taxpayer was not entitled to the deduction. While the precise nature of the expenses, and whether

they included commissions, does not appear, the general nature of the expenses was similar to those involved in the present case, but the two courts reached opposite results.

2. The question presented is of considerable general importance. Many bond issues of railroads and other corporations, marketed before 1913, are still outstanding, and in the case of many of them commissions were paid to bankers when the bonds were sold. The question whether such commissions may be amortized, and the current year's proportion deducted from gross income, arises each year in the case of each such taxpayer.

3. The decision below is believed to be erroneous. The question arises under the Revenue Acts of 1918 and 1921. Section 234 of each of those Acts (*infra*, p. 9), like corresponding provisions of the Acts before and since, allowed deduction of expenses paid or incurred, interest paid or accrued, and losses sustained, during the taxable year. These commissions, whether regarded as expenses, extra interest, or losses, were incurred and paid in 1904, 1907, and 1908, and it is only by a fiction of accounting that any part of them can be regarded as falling in any of the years 1920–1923.

It is perfectly true that such commissions substantially resemble discounts on bonds sold, which are in turn the converse of bond premiums. It is also true that when such items, whether premium, discount, or commission, upon a bond issue having several years to run, are wholly charged or credited to

income in a single year, the income account for that year is distorted. For that reason the regulations of the Treasury Department (*infra*, p. 9) under the Revenue Acts of 1918 and 1921 provided that both bond discount and bond premium should be amortized over the life of the bonds. While the regulations were silent as to commissions paid to bankers, and other like expenses, the Treasury rulings show that they were treated, at that time, like discounts. O.D. 936, 4 Cumulative Bulletin 276; O.D. 959, 4 Cumulative Bulletin 129; I.T. 1412, I–2 Cumulative Bulletin 91; I.T. 1962, III–1 Cumulative Bulletin 291; S.M. 3691, IV–1 Cumulative Bulletin 145.

Before the decision of this Court in *Old Colony Railroad Co.* v. *Commissioner*, 284 U.S. 552, these rules were applied alike to premium, discount, and expense, whether the securities were issued before or after March 1, 1913. They are still so impartially applied when the securities were issued after that date, as the decision in the *Old Colony Railroad* case permits. 284 U.S. 552, 558; Regulations 77, Article 68, *infra*, p. 10. But in respect of securities put out before the income tax became effective, recent decisions, of which the present case is one, have resulted in a difference of treatment, and in inequality.

Under the decision in *Old Colony Railroad Co.* v. *Commissioner*, *supra*, premiums received before March 1, 1913, may not be prorated to later years. The Board of Tax Appeals had held, before this Court's decision in that case, that discounts suffered on sales before that date must be prorated (*C., R. I. &*

P. Ry. Co. v. *Commissioner*, 13 B.T.A. 988, 1027–1034; see also *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695, 696–697) (C.C.A. 4th); and it has in this case followed the same rule, and the Circuit Court of Appeals has held the same as to commissions. As to premiums and discounts, the regulations have been amended to conform to these divergent holdings. Regulations 77, Art. 68, *infra*, p. 10. But the plain fact is that neither discounts nor commissions differ in principle from premiums. The only difference is that the shoe is on the other foot.

The court below was of opinion that these commissions were a "loss" and that "the loss is actually sustained when the bonds are paid or redeemed" (R. 102), when, presumably, there will still be an income tax. Such reasoning seems wholly artificial. A commission paid to bankers for floating an issue of securities is not a "loss" in any ordinary sense. It is a sum of money paid for services, which presumably are worth the payment. Such expenses are incurred when the services are rendered, and paid when the services are paid for, not twenty or a hundred years thereafter when the securities mature. If the view taken by the court below in this respect were followed, then an issuer of bonds, which became insolvent and never paid them off, would never have paid the commissions which it did pay when the bonds were issued.

The question as to discounts, taken before 1913, is not open in this case, because the Commissioner did not appeal from the adverse decision of the Board of Tax Appeals upon that point. But the question of

commissions is open, and for the reasons stated it is believed that it deserves review.

Wherefore it is respectfully submitted that this petition for a writ of certiorari, to review, upon the single question stated, the judgment of the Circuit Court of Appeals for the Second Circuit, should be granted.

J. CRAWFORD BIGGS,
Solicitor General.

MAY 1934.

APPENDIX

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077:

> Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *
>
> (2) All interest paid or accrued within the taxable year on its indebtedness * * *
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> * * * * *

Revenue Act of 1921, c. 136, Sec. 234, 42 Stat. 227, 254, contains substantially identical provisions.

Treasury Regulations 45 (1920 Ed.), under the Revenue Act of 1918:

> Art. 544. * * *
>
> (2) (a) If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. * * *
>
> (3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

Treasury Regulations 62 (1922 Ed.), under the Revenue Act of 1921, Art. 545, contains identical provisions.

Treasury Regulations 77, under the Revenue Act of 1932:

> Art. 68. * * *
>
> (2) (a) If bonds are issued by a corporation subsequent to February 28, 1913, at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. * * *
>
> (3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *
>
> (4) (a) If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was gain or income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1934

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In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 51

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

UNION PACIFIC RAILROAD COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 41) is reported in 26 B. T. A. 1126. The opinion of the Circuit Court of Appeals (R. 97) is reported in 69 F. (2d) 67. The part of the opinion of the Board of Tax Appeals dealing with the question here sought to be reviewed commences at R. 52 and that of the Circuit Court of Appeals at R. 101.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 20, 1934 (R. 103). A petition of the taxpayer for rehearing was denied

March 14, 1934 (R. 105). The petition for certiorari was filed May 19, 1934, and granted October 8, 1934. The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer kept its books on the accrual basis, and it and the Oregon Short Line Railroad Company made consolidated returns. The taxpayer and the Oregon Short Line had both marketed issues of bonds prior to 1913, and in that connection had incurred and paid commissions to bankers. May the current year's proportion of the amortization of these commissions be subtracted in determining taxable net income in 1920, 1921, 1922, and 1923?

STATUTES AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra,* pp. 17–18.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 52) may be summarized as follows:

Prior to 1913 the Union Pacific Railroad Company and its subsidiary, the Oregon Short Line, sold three issues of bonds at varying rates of discount, and in connection with the sales paid commissions to bankers. The railroads claimed deductions in the taxable years 1920, 1921, 1922, and 1923 for these discounts and commissions, amortized over the life of the bonds. The aggregate amount of the deductions claimed each year on account of

discounts was $251,896.55, and on account of commissions, $57,252.57 (R. 52). The issues of bonds, the commissions paid, and the amortization of commissions, as shown by the petition to the Board of Tax Appeals, the allegations of which on this point were admitted by the answer (R. 82), were as follows:

In 1904 the Oregon Short Line sold an issue of Refunding bonds maturing on December 1, 1929, upon which it paid commissions amounting to $960,000, which, amortized over the twenty-five-year life of the bonds, gives $38,400 as the yearly amortization of commissions (R. 23–24).

In 1907 the Union Pacific sold an issue of Twenty-Year Convertible bonds upon which it paid commissions amounting to $134,176, which amortized over the twenty-year life of the bonds, gives $6,708.80 as the yearly amortization of the commissions (R. 19–20).

In 1908 the Union Pacific sold an issue of First Lien and Refunding bonds maturing in 2008, upon which it paid commissions amounting to $1,214,377.16, which, amortized over the one-hundred-year life of the bonds, gives $12,143.77 as the yearly amortization of the commissions (R. 21).

The Board of Tax Appeals decided that the taxpayer was entitled to the deductions claimed on account of bond discount, but not on account of commissions (R. 53). As to the commissions, the taxpayer appealed to the Circuit Court of Appeals, which reversed the Board of Tax Appeals (R. 101–103).

SPECIFICATION OF ERRORS TO BE URGED

1. The Circuit Court of Appeals erred in holding that the taxpayer could deduct the amortized commissions on bonds issued prior to 1913.

2. The Circuit Court of Appeals erred in holding that the commissions paid on bonds issued prior to 1913 are losses within the meaning of Section 234 (a) (4) of the Revenue Acts of 1918 and 1921, that they will not be suffered until the bonds mature, and that they may be amortized over the life of the bonds.

3. The Circuit Court of Appeals erred in reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

There is no provision in the statute or the regulations permitting the amortization and deduction of commissions on bonds issued prior to 1913. There was formerly such a provision in the Treasury Regulations, but it was omitted in the regulations from 1918 on. In the absence of a provision in the statute or in the regulations expressly granting the right to make the deduction, the taxpayer is not entitled to it.

As to bonds issued after 1913, the Treasury Department permits taxpayers to amortize and deduct commissions, as well as other expenses incidental to the sale of bonds. This right is not derived from the statute or the regulations, which are silent as to commissions, but is granted as a matter of administrative practice. There are a number

of published rulings confirming this practice. As to premiums and discount on bonds issued after 1913, the Treasury Regulations expressly authorize the amortization of these items over the life of the bonds. Therefore premiums, discount, and commissions, all of which are generally similar and relate to the obtaining of new capital, are treated alike.

As to premiums and discount on bonds issued before 1913, the Treasury Regulations formerly authorized the amortization of both premiums and discount. About two years ago, however, this Court held that the part of the regulations which required the amortization of premiums was invalid. The Treasury Department has continued to permit the amortization of discount, although the new regulations expressly provide that premiums need not be amortized. It is anomalous and unreasonable to treat premiums in one way and discount in another. Therefore the regulations are incorrect in so far as they fail to eliminate the amortization of discount as well as of premiums. Conceding that commissions and other expenses are analogous to discount and premiums, in order to attain uniformity of treatment for premiums, discount, and commissions on bonds issued before 1913, it is proper that they likewise should not be amortized.

ARGUMENT

The commissions sought to be amortized in this case were paid prior to March 1, 1913, and we sub-

mit that in this respect the question presented is similar to the amortization of premiums. In *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, this Court settled the proposition that premiums on bonds issued prior to March 1, 1913, are not the proper subject of amortization, from which we think it follows that commissions on bonds issued prior to March 1, 1913, should not be amortized.

Section 234 of the Revenue Acts of 1918 and 1921, *infra,* p. 17, like corresponding provisions of the Acts before and since, allowed deduction of expenses paid or incurred, interest paid or accrued, and losses sustained, during the taxable year. These commissions, whether regarded as expenses, extra interest, or losses, were incurred and paid in 1904, 1907, and 1908, and it is only by a fiction of accounting that any part of them can be regarded as falling in any of the years 1920 to 1923. Furthermore, there is no provision in Treasury Regulations 45, relating to the Revenue Act of 1918, or in Treasury Regulations 62, relating to the Revenue Act of 1921, which permits the deduction of commissions paid for the sale of bonds and the amortization of such amounts over the life of the bonds. In the absence of a provision in the statute or in the regulations expressly granting the right to make the deduction, the taxpayer is not entitled to it.

The court below recognized the difficulty of finding some support in the statute for the deduction. The court said (R. 102):

It is not easy to select the precise provision of the statute which authorizes amortization and deduction either of bond discount or bond commissions. The petitioner has not attempted to pin its flag to a single specific phrase. Section 234 is the relevant section in both the Revenue Act of 1918 (40 Stat. 1077) and the Revenue Act of 1921 (42 Stat. 254). Separate paragraphs authorize the deduction from gross income of "ordinary and necessary expenses paid or incurred during the taxable year", of "interest paid or accrued", of "losses sustained", and of depreciation and exhaustion. Bond discount and commissions scarcely fall within the first category; they represent the cost of acquiring new capital, rather than an ordinary and necessary expense in carrying on business during the year. Discount is often referred to as deferred interest, and deduction of amortized discount has been allowed under the "interest" paragraph. See *Western Maryland* case, *supra*. To us the "loss sustained" paragraph seems the more appropriate.

There is only one other court decision dealing with the right to deduct expenses in connection with the sale of bonds issued prior to 1913.[1] In

[1] Under Article 150 of Treasury Regulations 33, relating to the Revenue Act of 1916, taxpayers were expressly permitted to amortize and deduct commissions, as well as discount. Treasury Regulations 45 and 62 and all later regulations continued the right to deduct discount but omitted any reference to commissions and other expenses incidental

Chicago, R. I. & P. Ry. Co. v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7th), certiorari denied, 284 U. S. 618, the taxpayer sold prior to 1913 bonds maturing in 1934. The expenses of selling the bonds, which amounted to about $250,000, were charged to profit and loss on the dates of sale. The taxpayer claimed a *pro rata* expense deduction for the years 1916 to 1919, inclusive, for the cost of issuing and selling the bonds, but the court held that the taxpayer was not entitled to the deduction. While the precise nature of the expenses and whether they included commission does not appear, the general nature of the expenses was similar to those involved in the present case. The principle which controlled that case is the one which we invoke here, namely, that since premiums on bonds sold prior to March 1, 1913, could not be prorated over the life of the bonds, it follows that expenses incurred and charged off prior to March 1, 1913, should not be allowed as deductions from income in subsequent years.

There is a recent decision which holds that commissions paid for the sale of a taxpayer's bonds issued after 1913 may be deducted as an ordinary

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to issuing bonds. Nevertheless, it appears that the Commissioner in fact continued to permit taxpayers to amortize and deduct commissions on bonds issued prior to 1913 under the conditions of Article 150 of Treasury Regulations 33 until the decision of the Board of Tax Appeals in *Chicago, R. I. & P. Ry Co.* case, 13 B. T. A. 988, 1034. After that decision the practice of the Commissioner was not to permit the amortization of commissions on bonds issued before 1913.

and necessary expense of the business in the year that the bonds are issued, and that the Commissioner may not require the taxpayer to amortize the amount of the commissions over the life of the bonds. *Bonded Mortgage Co.* v. *Commissioner,* 70 F. (2d) 341 (C. C. A. 4th). That case concerned commissions on the sale of bonds issued after 1913,[2] and the court recognized that the decision was an exception to the general rule and applied only under the peculiar circumstances of that case.

The court below, however, reached the conclusion that these commissions were a loss within the meaning of the statute.

The reasoning to sustain the deduction of commissions as a loss seems wholly artificial. A commission paid to bankers for floating an issue of securities is not a loss in any ordinary sense. It is a sum of money paid for services, which presumably are worth the amount paid. Such expenses are incurred when the services are rendered, and paid when the services are paid for, not twenty or

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[2] With respect to bonds issued after 1913, the Treasury Regulations have been silent as to commissions. Treasury Regulations 45, Article 544; Treasury Regulations 62, 65, and 69, Article 545; Treasury Regulations 74 and 77, Article 68. But there are a number of Treasury rulings which permit the amortization and deduction of commissions on bonds issued after 1913. O. D. 936, 4 Cumulative Bulletin 276; O. D. 959, 4 Cumulative Bulletin 129; I. T. 1412, I–2 Cumulative Bulletin 91; I. T. 1962, III–1 Cumulative Bulletin 291; S. M. 3691, IV–1 Cumulative Bulletin 145.

a hundred years thereafter when the securities mature. If the view taken by the court below in this respect were followed, then an issuer of bonds, who afterwards became insolvent and never paid them off, would be regarded as never having paid the commissions which it actually did pay when the bonds were issued.

As to that part of the reasoning of the court below to the effect that commissions should be treated on the same basis as bond discount, we are inclined to agree. In fact, we believe that premiums, as well as discount and commissions, are all similar and should all be treated alike. Since they are incidental to the obtaining of new capital, they are not properly to be regarded as falling entirely in the year in which they occur. In the case of bonds issued after 1913, the Treasury Regulations provide for the amortization of premiums and discount, and the administrative practice and published rulings permit the amortization of bond commissions and other expenses incident to the sale of bonds.[3]

But in the case of bonds issued prior to 1913 there is no such uniform treatment of premiums and discount and commissions. Formerly the Treasury Regulations made no distinction as to premiums and discount between bonds issued prior to 1913 and those issued after that date. In *Old Colony R. Co.* v. *Commissioner, supra,* this Court

[3] See note 2, *supra.*

held inapplicable the part of the regulations [4] dealing with amortization of premiums upon bonds issued prior to 1913 because the regulations expressly provided that the net amount of premium is gain or income and the taxpayer received the premiums prior to the adoption of the Sixteenth Amendment. Previously it had been held by the Board of Tax Appeals [5] and the Circuit Court of Appeals for the Fourth Circuit [6] that discount on bonds issued prior to 1913 must be prorated. After the decision in the *Old Colony* case Treasury Regulations 77, relating to the Revenue Act of 1932, were promulgated. Article 68, *infra,* p. 18, provided that premiums on bonds issued after 1913 should be amortized and returned as income; discount should be amortized and deductible, without any reference to when the bonds were issued; and premiums on bonds issued prior to 1913 should not be amortized.[7]

In *Tait* v. *Western Maryland Ry. Co.,* 62 F. (2d) 933 (C. C. A. 4th), the Government sought to raise the question whether the provision of the regula-

[4] Article 545 of Treasury Regulations 62, relating to the Revenue Act of 1921.

[5] *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 13 B. T. A. 988, 1027–1034.

[6] *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695, 696–697.

[7] The earlier regulations have not been amended so as to distinguish between premiums on bonds issued prior to 1913 and those on bonds issued after 1913, but the practice of the Treasury Department is to amortize premiums only when the bonds were issued after 1913, in conformity with the rule laid down by this Court in the *Old Colony* case.

tions relating to discount on bonds issued prior to 1913 was affected by the decision of this Court in the *Old Colony* case, *supra*. The court found it unnecessary to pass upon the question, but queried (p. 934) whether premiums and discount should not be treated alike.

The Government abandoned the question of bond discount when the case was presented to this Court. 289 U. S. 620. In another case which was submitted after the decision of this Court in the *Old Colony* case, the Government did not raise the question of discount on bonds issued prior to 1913 and the court assumed the correctness of the regulations. *New York, C. & St. L. R. Co.* v. *Burnet,* 64 F. (2d) 152, 154 (App. D. C.). In the instant case the Board of Tax Appeals decided that the taxpayer could deduct the amortized discount on bonds issued prior to 1913 (R. 52–53) and the Commissioner did not raise the question in the court below. There have been no decisions in the courts as to the right to deduct discount on bonds issued prior to 1913, since the decision of this Court in the *Old Colony* case, and inasmuch as the Treasury Department permits taxpayers to continue to deduct discount on bonds issued prior to 1913 the question is not likely to arise.

The inconsistency of the Treasury regulations with respect to bonds issued prior to 1913 is brought into sharp relief by the facts of this case. Not only do the regulations permit the taxpayer to de-

duct discount whereas the practice of the Department does not permit the deduction of commissions, but the taxpayer has been permitted to deduct some of the commissions and not others. Those commissions which were paid to the bankers for bonds that they were obliged to take in accordance with the underwriting agreement were treated like discount, which the Board decided that the taxpayer could deduct and the Commissioner did not appeal. But commissions that were paid to the bankers for selling the bonds to other persons were held not deductible by the Board and the Commissioner.[8] The

[8] The detailed facts in this connection as shown by the amended petition in the Board of Tax Appeals, the allegations of which on this point were admitted in the answer (R. 41), were substantially as follows:

As to the convertible bonds.—This issue was made by the Union Pacific in 1907 and offered to its stockholders for pro rata subscription at $90. A firm of bankers formed an underwriting syndicate to guarantee the sale of the bonds at that price, and the railroad undertook to pay a commission of 2 percent to the syndicate and a commission of one-half of 1 percent to the syndicate managers. The stockholders of the railroad took only a few of the bonds, and the syndicate took up the issue under its guarantee, paying the subscription price of $90 less the commission of 2 percent. This 2 percent commission was treated as discount, and is included in the amortization of discounts allowed by the Board of Tax Appeals and from which the Commissioner did not appeal (R. 19–20, 52). The other one-half of 1 percent commission paid to the syndicate managers amounted to $134,176, which, amortized over the life of the bonds, gives $6,708.80 per annum, which is the amount mentioned in the findings of the Board of Tax Appeals (R. 19–20, 52). It is only this syndicate managers' commission

Commissioner's action amounts to a tacit admission that the distinction between discounts and commissions is tenuous and elusive.

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of one-half of 1 per cent, therefore, which is presently in issue.

As to the first lien and refunding bonds.—These bonds "were sold to the public by a firm of bankers for the account of said petitioner at the price of 95½, said bankers receiving a commission of 2½ percent" (R. 21). This commission amounted to $1,214,377.16, which amortized over the one hundred year life of the bonds gives as annual amortization $12,143.77, which is the amount mentioned in the findings of the Board of Tax Appeals (R. 21, 52).

As to the Oregon Short Line refunding bonds.—$40,000,000 of these bonds were issued, and were offered to the holders of maturing bonds, at $96. A firm of bankers formed a syndicate to guarantee the sale of the 40 million of bonds at 96, and the railroad agreed to pay commissions of 2 percent to the syndicate and 1 percent to the syndicate managers. Both commissions were to be paid upon the entire 40 million (R. 23).

28 million of the 40 million were taken by the holders of the maturing bonds at $96. The syndicate's commission of 2 percent on this amount of bonds was treated as commission. The other 12 million were taken by the syndicate pursuant to its guarantee at $96 less 2 percent, in other words, at $94. The 2-percent commission of the syndicate upon this 12 million of bonds was treated as additional discount. The syndicate managers' commission of 1 percent upon the entire 40 million was treated as commission (R. 24).

The total of the amounts treated as commission, therefore (2% on 28 million, plus 1 percent on 40 million) amounted to $960,000, which, amortized over twenty-five years, gives a yearly amortization of $38,400, which is the amount mentioned in the findings of the Board of Tax Appeals (R. 24, 52).

Conceding that commissions should be treated on the same basis as discount, we submit that in view of the decision of this Court in the *Old Colony* case, *supra,* discount could not properly be allowed on bonds issued prior to 1913. While the Treasury Regulations in their present form permit the deduction of discount on bonds issued prior to 1913, we believe that they are incorrect in that respect. Premiums and discount are both factors in determining the effective rate of interest,[9] and it is anomalous to treat premiums in one way and discount in another. Commissions, and other expenses similar to commissions, are expenses incident to the obtaining of new capital and therefore they are not properly to be regarded as falling entirely in the year in which they occur. However, premiums, discounts, commissions, and incidental expenses all stand on the same footing. Since this Court held that premiums on bonds issued before March 1, 1913, cannot be amortized, it follows that discounts, commissions, and expenses should not be.

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[9] See *Old Colony R. Co.* v. *Commissioner*, *supra*, at pp. 558–559. See also Accounting, Practice & Procedure, by Arthur Lowes Dickinson, pp. 66, 134; Accounting, Theory & Practice, by Roy B. Kester, Vol. II (2d ed.), pp. 367–368; Accounts in Theory and Practice, by Earl A. Saliers, pp. 171–172; Modern Accounting, by Henry Rand Hatfield, pp. 187–188.

CONCLUSION

The decision of the Circuit Court of Appeals with respect to the right of the taxpayer to deduct commissions on bonds issued prior to 1913 should be reversed.

Respectfully submitted.

J. CRAWFORD BIGGS,
Solicitor General.

FRANK J. WIDEMAN,
Assistant Attorney General.

J. LOUIS MONARCH,
MORTON K. ROTHSCHILD,
Special Assistants to the Attorney General.

H. BRIAN HOLLAND,
Attorney.

OCTOBER 1934.

APPENDIX

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *;
>
> (2) All interest paid or accrued within the taxable year on its indebtedness * * *;
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; * * *

Revenue Act of 1921, c. 136, Sec. 234, 42 Stat. 227, 254, contains substantially identical provisions.

Treasury Regulations 45 (1920 ed.), under the Revenue Act of 1918:

> ART. 544. * * *
>
> (2) (*a*) If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. * * *
>
> (3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

Treasury Regulations 62 (1922 ed.), under the Revenue Act of 1921, Art. 545, contains identical provisions.

Treasury Regulations 77, under the Revenue Act of 1932:

ART. 68. * * *

(2) (*a*) If bonds are issued by a corporation subsequent to February 28, 1913, at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. * * *

(3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

(4) (*a*) If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was gain or income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1934

COPY

...e Court of the United States.

OCTOBER TERM, 193...

No. 31.

...RELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

UNION PACIFIC RAILROAD COMPANY,

Respondent.

...ER TO PETITION FOR WRIT OF CERTIORARI.

HENRY W. ...

Counsel for Respondent,

120 Broadway,

New York City.

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Supreme Court of the United States.

OCTOBER TERM 1934.

No. 51.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

UNION PACIFIC RAILROAD COMPANY.

ANSWER TO PETITION FOR WRIT OF CERTIORARI.

UNION PACIFIC RAILROAD COMPANY, respondent in the above entitled proceeding, submits the following answer to the Commissioner's petition for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit on the question of the allowance of amortization of commissions incurred on bond issues prior to 1913.

1.

THE POINT AGAINST AMORTIZATION OF PRIOR-TO-1913 BOND COMMISSIONS IS MERELY AN ATTEMPT TO SALVAGE SOMETHING OUT OF THE COMMISSIONER'S DEFEAT IN A LONG STANDING CONTROVERSY WITH CORPORATE TAXPAYERS IN WHICH THE RIGHT TO AMORTIZATION OF BOND DISCOUNT, WHENEVER INCURRED, WAS ESTABLISHED. THE POINT IS WITHOUT MERIT.

A narrative of a prolonged controversy is necessary to the Court's understanding, in proper perspective, of the question presented by the Commissioner's certiorari application.

Amortization of discount, commissions and expenses on bond issues always recognized if incurred after March 1, 1913.

From the beginning of its administration of the income tax laws the Bureau of Internal Revenue in its official regulations recognized the right to deduct annual amortization of discount incurred on the issue of corporate bonds and in fact required amortization (Article 135 of *Regulations 33,* governing the administration of the 1913 law). The same regulations as revised to govern the administration of the 1916 law expressly included in such annual amortization the commissions and incidental expenses incurred in connection with bond issues (Article 150 of *Regulations 33 revised*). Subsequent regulations governing the later income tax laws have all required the annual amortization of discount. While the subsequent regulations have not contained express mention of commissions and incidental expenses, it has at all times continued to be the practice of the Bureau to amortize commissions and incidental expenses as well as discount (see administrative rulings cited on page 6 of the petition).

Bureau made exception, however, against amortization of prior-to-1909 bond discount.

The general rule above stated was however subject to an exception to the effect that such amortization would not be allowed in case the bonds had been sold prior to 1909 and the discount charged to income or profit and loss in the year of issue (*Treasury Decision* 2161, dated February 19, 1915, and Article 149 of *Regu-*

lations 33 revised). This exception was based on the theory that the charging off of the entire discount in some year prior to the incidence of the Corporation Excise Tax Act of 1909, being the first income tax law, constituted a conclusive election to treat the discount as a closed transaction. This theory was directly contrary to the elementary rule that income tax liability is not to be determined by bookkeeping.

Board and Courts overruled exception and recognized amortization of bond discount whenever incurred.

The above stated position of the Bureau was at first sustained by the Board of Tax Appeals in *Western Maryland Railway Co.*, 12 B. T. A. 889, 907. That decision was, however, shortly thereafter reversed by the Board itself in *Chicago, Rock Island & Pacific Railway Co.*, 13 B. T. A. 988, 1027-1034, which held that the amortization of discount must be recognized equally whether the bonds were sold prior to the incidence of the income tax laws or thereafter and regardless of the taxpayer's method of accounting for the discount. The Commissioner did not appeal. The decision to the contrary in the *Western Maryland* case was reversed by the Circuit Court of Appeals for the Fourth Circuit in 33 Fed. (2d) 695, 696, and the Commissioner did not seek certiorari.

The Board has consistently followed its decision in the *Rock Island* case as to discount amortization (*Kansas City Southern Ry. Co.*, 16 B. T. A. 665, 686; *St. Louis Terminal Railroad Association*, 17 B. T. A. 1135, 1169; *Chicago & North Western Railway Co.*, 22 B. T. A. 1407, 1435).

Exception made in Rock Island case against amortization of incidental expenses of prior-to-1913 bond issues.

The *Rock Island* case, *supra,* involving the question of prior-to-1909 discount, also involved among numerous other questions the question of amortization of incidental expenses of several bond issues the last of which had been sold in 1908. The Bureau, consistently with its position as to the bond discount, denied the right to such amortization and in the interest of a more complete consistency advanced an affirmative claim that its allowance previously made to the Rock Island of amortization of incidental expenses of certain bond issues sold in 1917 and 1919 was erroneous, 13 B. T. A. 1034-1035. The Board held that the amortization of the expenses of the *later* bond issues was proper, since such expenses constituted a part of the cost of the borrowed money. But it held that the expenses incidental to the *earlier* bond issues were not entitled to amortization, on the ground that: "since the "Circuit Court of Appeals has held in the *Old Colony "Railroad Co.* case, *supra,* (referring to *Commissioner* v. *"Old Colony Railroad Co.,* 26 Fed. (2d) 408) that "premiums actually received prior to March 1, 1913, are "not taxable income, by the same token, expenses actually "paid prior to said date are not deductible from gross "income of taxable years".

This decision as to prior-to-1913 expenses was affirmed by the Circuit Court of Appeals for the Seventh Circuit in 47 Fed. (2d) 990, 991. The taxpayer petitioned for a writ of certiorari which was denied by this Court, 284 U. S. 618.

Thereupon the Bureau naturally sought to differentiate commissions from discount and disallow amortization of prior-to-1913 commissions as analogous to incidental expenses.

When the Bureau was defeated, as above shown, as to prior-to-1909 discount but was sustained as to prior-to-1913 incidental expenses there were pending some other railroad cases involving the question of amortization of prior-to-1909 bond discount. In an endeavor to salvage as much as possible out of the defeat on the discount question, the Bureau asserted in these cases a distinction between strict discount and commissions to bankers and underwriters and took the position that such commissions were ruled by that part of the decision in the *Rock Island* case, *supra,* against the amortization of prior-to-1913 expenses rather than by that part of the same decision in favor of the amortization of prior-to-1909 bond discount. The first case to come before the Board on this issue was that of the *Kansas City Southern Railway Co.,* 22 B. T. A. 949, 966. The Board decided without discussion that the amortization of prior-to-1913 commissions was not allowable, citing its decision as to the amortization of prior-to-1913 expenses in the *Rock Island* case. When the Union Pacific Railroad Company's cases, out of which the present certiorari application grows, came before the Board the Commissioner contested the allowance of commissions incurred prior to 1913, although conceding that the right to deduct amortization of discount, whenever incurred, was established (Board opinion, Transcript, pp. 52-53). The Board disallowed the amortization of such commis-

sions on the authority of its decisions against amortization of prior-to-1913 expenses in the *Rock Island* case, *supra,* and against the amortization of prior-to-1913 commissions in the *Kansas City Southern* case, *supra.* The Circuit Court of Appeals for the Second Circuit has reversed the Board on this point (Tr. pp. 101-103). It is this action which the Commissioner seeks certiorari to review.

The decision below sustaining the amortization of prior-to-1913 commissions is obviously sound.

The opinion of the court below, reversing on the commission amortization point the decision of the Board, is an able presentation in support of its conclusion. The opinion says (Tr. p. 101) that petitioner "argues with persuasive force that commissions should be dealt with on the same basis as discount." In other words, the court agreed with our contention that there is a complete analogy between discount and commissions and that the decisions establishing the right to amortization of prior-to-1909 discount should be taken as establishing the right to the amortization also of prior-to-1913 commissions. However, the opinion did not rely wholly upon this reasoning, and the allowance of the amortization may be sustained upon other grounds.

The principle controlling the decision of the point in question is so simple and elementary, whether the application is to discount or commissions or incidental expenses, that this general controversy ought not to have been so greatly prolonged. The persistence of the Bureau

in developing from the main controversy separate questions as to amortization of incidental expenses and amortization of commissions after the correct principle was discovered and applied to the discount question in the *Rock Island* case, 13 B. T. A. 988, 1027, has been unjustifiable.

The specification of allowable deductions in Section 234(a) of each of the income tax laws of 1918 and 1921, taken as a whole, evidences a broad policy to allow the corporation to deduct under one name or another the entire cost of conducting its business. Separate paragraphs authorized the deduction of ordinary and necessary expenses, of interest, of depreciation and exhaustion, of losses and other items of cost not here material. Any item of cost of doing business which is properly applicable to the tax year is chargeable against the income of that year, regardless of when it was paid. If a payment is made in advance which is clearly applicable to future years, or if a liability is incurred which is applicable to years prior to its maturity, amortization is essential in order to reflect correctly the income of the several tax years. This principle is and always has been fully recognized by the Bureau with the exception only of the confusion in which it became involved as to amortization of items growing out of bond issues made prior to 1913.*

---

* Note: A current ruling on amortization is found in General Counsel's Memorandum 13148 published in the Internal Revenue Bulletin dated June 18, 1934 (Volume XIII, No. 25, page 2) which is so enlightening upon the general practice of the Bureau not merely to recognize but to require amortization as to a wide variety of expenditures that we print it in full in an appendix hereto.

Under the principle last stated it is immaterial that the advance payment was made or the liability incurred prior to March 1, 1913. Any portion of the payment or liability properly apportionable to tax years subsequent to March 1, 1913, is a cost of doing business in those years and does not represent an expense *incurred for years prior to 1913.*

So, in the present case, if the commissions on the bond issues made prior to 1913 be considered as deducted, like the discount, from the amount of the loan at the time of the bond issue, then no disbursement prior to 1913 is involved, but a liability was created to be met at the maturity of the bonds, which liability represents a cost incurred in securing the loan and which should, in anticipation of maturity, be prorated annually over the life of the loan. This is the view which the Court below preferred (Tr. pp. 102-103). But, if on the other hand the commissions be considered as disbursements made at the time of the bond issue, they nevertheless represented an advance payment of the cost of the loan and of the use of the borrowed capital which should be amortized over the life of the loan, and the amount apportionable to the tax years represented a cost of doing business in those years and not an expense of the year in which the bonds were issued. In neither view of the matter does the fact that the transaction originated prior to 1913 have any significance.

Commissions on bond issues bear a close analogy to improvements made by a lessee upon leased property which will revert to the lessor at the end of the term. The amortization of the cost of such improvements is allowed. See *Kunkel & Co.,* 3 B. T. A. 133, 138-9, and *Strand*

Amusement Co., 3 B. T. A. 770, 776. In Solicitors Recommendation 2499 (Cumulative Bulletin, Vol. IV-1, p. 142), such amortization was recognized and without a suggestion that the right was in any wise affected by the fact that the improvements there considered were made prior to 1913.

2.

THERE IS NO CONFLICT OF DECISIONS.

The petition advances as a reason for granting the writ that the decision of the Circuit Court of Appeals for the Second Circuit in this *Union Pacific R. R. Co.* case is in conflict with the decision of the Circuit Court of Appeals for the Seventh Circuit in the *Rock Island* case, 47 Fed. (2d) 990, to which we have already referred.

The assertion of a conflict is necessarily based on the premise that the *commissions* to bankers and underwriters in connection with the bond issues involved in this *Union Pacific* case and the *incidental expenses* of bond issues involved in the *Rock Island* case are equivalent subject matters. The premise is unsound.

In this *Union Pacific* case commissions on three bond issues were involved. In the case of Union Pacific Railroad Company's convertible bonds sold in 1907 commissions amounting to $134,176 were allowed to bankers for their services as syndicate managers. In the case of Union Pacific Railroad Company's first lien and refunding bonds sold in 1908 commissions amounting to over $1,214,000 were allowed to bankers as their compensation for selling the bonds to the public. In the case of Oregon Short Line Railroad Company's refunding bonds sold in 1904

commissions amounting to $960,000 were allowed in part to an underwriting syndicate and in part to bankers for forming and managing the syndicate. The commissions ranged from the rate of ½ of one per cent to 2½ per cent. The facts were fully pleaded in the amended petition to the Board (Tr. pp. 19 to 25) and admitted by answer (Tr. p. 28).

The character of the incidental expenses of bond issues which were the subject matter of the expense amortization point in the *Rock Island* litigation was not shown. The findings of fact show merely schedules of various bond issues, giving the amounts issued and with a column headed "Expense (charged to profit and loss on date of sale)" in which the amounts claimed were entered. (See findings in *Rock Island* case, 13 B. T. A. 988, at p. 1010.) It is a fair inference that these expenses were the incidental expenses of bond issues such as printing, engraving, stock exchange fees, etc., and did not include commissions to underwriters or bankers. The amounts claimed in the expense column do not constitute one-half of one per cent. of the aggregate of the bonds issued and, therefore, commissions were clearly not involved.

The decision of the Circuit Court of Appeals for the Seventh Circuit in the *Rock Island* case, 47 Fed. (2nd) 990, cited as conflicting with the decision below and dealing with expenses of an undescribed character, might well have been different had bankers and underwriters commissions constituted the subject-matter. In that case that court might have reached the same conclusion as the court below in this *Union Pacific* case, based on the inherent analogy between such commissions and strict discount, both of which are in their nature capital items.

Further, the determination as to what expenditures in any transaction deserve amortization necessarily involves the exercise of some discretion concerning the facts and does not present exclusively a question of law. That is to say, certain items of expense may be too trivial in amount or of too unimportant a character to deserve the dignity of amortization over a long period, and this may be so even though they constitute, together with other classes of items, a substantial aggregate. Therefore, it cannot be said as a matter of law that there is error in a decision denying amortization to a claim for expenses aggregating less than one-half of one per cent of the face amount of a bond issue and unaccompanied by any specification or description of the items making up the aggregate claim. This Court's denial of certiorari in the *Rock Island* case, 284 U. S. 618, may well have been upon the consideration last mentioned and in any event is not entitled to be regarded as an affirmance on the merits.

The reasoning of the Board of Tax Appeals and the Circuit Court of Appeals for the Seventh Circuit in the *Rock Island* case that the decisions* in the *Old Colony* litigation* against the amortization of prior-to-1913 bond *premiums* control the question of the deduction of amortization of prior-to-1913 *expenses* was clearly erroneous. There is no constitutional problem concerning *deductions* from income. Deductions are a mere matter of statute

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*(*Old Colony Railroad Co.*, 6 B. T. A. 1025; affirmed in *Commissioner* v. *Old Colony Railroad Co.*, 26 Fed. (2nd) 408; certiorari granted but dismissed on motion of petitioner, 279 U. S. 876. Second litigation: *Old Colony Railroad Co.*, 18 B. T. A. 267, 275; reversed in *Commissioner* v. *Old Colony Railroad Co.*, 50 Fed. (2nd) 896; reversed in 284 U. S. 552).

and as to them Congress is not controlled by any constitutional restriction. An undue burden would be imposed on this respondent by the granting of the Commissioner's application for certiorari in the present case simply to the end that this Court have an opportunity to express its disapproval of the unsound reasoning on which the Circuit Court of Appeals for the Seventh Circuit based its decision in the *Rock Island case*. A denial of this application for certiorari would evidence the judgment of this Court that the two decisions are not conflicting. It would leave the decision in the *Rock Island* case to stand as denying, in the case of prior-to-1913 bond issues, the amortization of incidental expenses of a miscellaneous character. It would not foreclose the assertion by any litigant of a claim that some particular expenses of a bond issue were of such amount and importance as to deserve amortization equally with commissions under the decision in this case. No serious injustice would be occasioned, considering the less important amounts involved in the miscellaneous incidental expenses of bond issues relatively to the amounts of commissions.

Conclusion.

The petition should be denied.

June 29, 1934.

Respectfully submitted,

HENRY W. CLARK,
Counsel for Respondent,
120 Broadway,
New York City.

Appendix.

INTERNAL REVENUE BULLETIN.

June 18, 1934. Vol. XIII, No. 25.

General Counsel's Memorandum 13148.

REVENUE ACTS OF 1918, 1921, 1924, 1926, 1928, and 1932.

Where insurance premiums are deductible as business expenses and are paid in advance for a period of more than one year, only the pro rata part of such payment is allowable as a deduction each year, regardless of whether the income is reported on the cash receipts and disbursements basis or on the accrual basis.

Advice is requested relative to the proper treatment, for Federal income tax purposes, of insurance premiums paid in advance by a taxpayer who renders returns on the basis of cash receipts and disbursements, where such premiums are deductible as business expenses.

Section 41 of the Revenue Act of 1932 provides in part as follows:

> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

Similar provisions are contained in the Revenue Acts of 1918 to 1928, inclusive.

In *Appeal of J. Alland & Bro., Inc.* (1 B. T. A., 631), the Board of Tax Appeals held that a taxpayer keeping its books of account upon the cash receipts and disbursements basis for 1921 is not entitled, under the provisions of section 234(a)1 of the Revenue Act of 1921, to deduct in its income tax return for 1921 any part of a bonus or advance rental paid by it under an agreement of lease upon premises which it was to occupy on and after January 1, 1922. In the course of its opinion, the Board commented as follows:

> * * * The tax is an annual tax. The theory of the law is that the true gains of each year shall be subjected to the tax. Where, therefore, a taxpayer claims that it is entitled to deduct from gross income an amount which is not clearly an expense item properly chargeable against the gross income of the particular year, it is incumbent upon the taxpayer to show that it is at least within the letter of the provision of the law permitting the deduction.

(See also *J. Alland & Bro., Inc.* v. *United States,* 28 Fed. (2d), 792).

Commissions paid for the purpose of securing long-term leases have been consistently held to constitute capital expenditures deductible ratably over the term of the lease even though the taxpayer's accounts are kept on the cash basis. (*E. N. Webb* v. *Commissioner,* 20 B. T. A., 274; *Mary C. Young* v. *Commissioner,* 20 B. T. A., 692; *Evalena M. Howard* v. *Commissioner,* 19 B. T. A., 865; *S. M. Clawson* v. *Commissioner,* 19 B. T. A., 1253.)

In *Julia Stow Lovejoy* v. *Commissioner* (18 B. T. A., 1179), the taxpayer, whose returns were rendered on the cash basis, paid fees, commissions, and printing costs in securing a loan over a period of years. In disallowing the amounts so paid as a deduction in the year of payment, the Board said:

> In its essence such a disbursement is not unlike bond discount, prepaid rent, cost of acquiring or disposing of a leasehold or term contract and many other transactions. They should be spread over the definite period of the loan, lease, or contract. (*Chicago, Rock Island & Pacific Railway Co.*, 13 B. T. A., 988; *J. Alland & Bro., Inc.*, 1 B. T. A., 631; *Alland* v. *United States*, 28 Fed. (2d) 792; *United States Playing Card Co.*, 15 B. T. A., 975; *Bonwit Teller & Co.*, 17 B. T. A., 1019.) This is on the theory that they result in property of a sort and its cost is being exhausted proportionately over a period of years and should be provided for on the basis of time, production, or otherwise. (Section 214(a)8.)

In *Higginbotham-Bailey-Logan Co.* v. *Commissioner* (8 B. T. A., 566), where the petitioner's accounts were kept on the accrual basis, the Board approved the Commissioner's adjustment of interest and insurance payments on the basis of prorating such payments over the period for which made. The Board stated in part that—

> * * * The payment in advance of premiums for insurance results in the creation of an asset, since the policy has a surrender value. The asset value is exhausted ratably over the term for which the premium is paid. In the balance sheet such items are often carried as assets under such terms as prepaid insurance, or prepaid expense. * * *

The payment in advance of insurance premiums by a taxpayer rendering returns on the cash receipts and disbursements basis likewise results in the creation of an asset. In order to reflect clearly the income of such taxpayer, only the amount applicable to carrying such insurance for the taxable year constitutes an ordinary and necessary expense in the earning of the income for that year.

It is, therefore, the opinion of this office that where insurance premiums are deductible as business expenses and are paid in advance for a period of more than one year, only the pro rata part of such payment should be allowed as a deduction each year, regardless of whether the income is reported on the cash receipts and disbursements basis or the accrual basis.

ROBERT H. JACKSON,
General Counsel, Bureau of Internal Revenue.

FILE COPY

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Supreme Court of the United States

OCTOBER TERM, 1934.

No. 51.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

UNION PACIFIC RAILROAD COMPANY

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

BRIEF FOR RESPONDENT

The Evening Post Job Printing Office, Inc., 134 Fulton St., New York, N. Y.

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IN THE

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v.

UNION PACIFIC RAILROAD COMPANY

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit

---

BRIEF FOR RESPONDENT.

The opinion of the Board of Tax Appeals (Transcript, p. 41) is reported in 26 B. T. A. 1126. The opinion of the Circuit Court of Appeals (Transcript, p. 97) is reported in 69 Fed. (2d) 67. The part of the opinion of the Board of Tax Appeals dealing with the question here sought to be reviewed commences at page 52 and that of the Circuit Court of Appeals at page 101 of the transcript.

Statement of the Case.

The question presented is the right to a deduction in each of the tax years, 1920, 1921, 1922 and 1923, of the annual amortization of commissions to bankers and underwriters incurred on three bond issues sold prior to 1913.

The facts regarding the several bond issues are briefly but sufficiently stated in the Commissioner's brief at page 3 and more fully in a footnote on pages 13 and 14. Such statements are satisfactory to the respondent, subject, however, to the comment that no inference can properly be drawn that the payment of the commissions in any of the three cases was a cash disbursement to the bankers and underwriters by the corporation issuing the bonds rather than a deduction of the amount of the commissions by the bankers and underwriters in paying over to the corporation the proceeds of the sale of the bonds. It being our opinion that the question of law as to the propriety of the amortization deduction ought not to turn upon the manner in which the payment was handled, the facts were so pleaded in the petition to the Board of Tax Appeals as to avoid a definite showing as to the method by which the liability for commissions was satisfied. See amended petition for 1920-22, pages 19 to 25 of the transcript, and for the year 1923 at pages 33 to 39 of the transcript.

Commissioner's Contention.

In contending that commissions incurred on bond issues made prior to 1913 are not entitled to amortization deduction in current tax years, the argument submitted in the Commissioner's brief is:

(1) That since annual amortization of *premiums* realized on bond issues prior to 1913 may not be subjected to taxation as income of the current tax years, as held by this Court in *Old Colony R. R. Co.* v. *Commissioner,* 284 U. S. 552, it is "anomalous and unreasonable" to allow the deduction of amortization of prior-to-1913 *discount,* as the current Treasury Regulations do; and

(2) That, since commissions are analogous to discount and premiums, uniformity of treatment requires that discount and commissions, as well as premiums, on prior-to-1913 bond issues, all be denied recognition.

The first proposition above concededly involves the repudiation of the recognition in the official regulations of the deduction of discount amortization so far as discount prior to 1913 is concerned, although such recognition was compelled by court and Board of Tax Appeals decisions from which the Commissioner did not appeal.

The second proposition above involves a reversal of the position taken in behalf of the Commissioner below. It was contended below that commissions were *not* analogous to discount and hence were not entitled to amortization under the decisions which Commissioner was then accepting as establishing the right to deduction of amortization of discount incurred prior to 1913.

Development of the Question.

This question as to commissions is a tag-end of a long controversy, and a narrative of that whole controversy is necessary to the Court's understanding in proper perspective of the question presented.

Amortization of discount, commissions and expenses on bond issues always recognized if incurred after March 1, 1913.

From the beginning of its administration of the income tax laws the Bureau of Internal Revenue in its official regulations recognized the right to deduct annual amortization of discount incurred on the issue of corporate bonds and in fact required amortization (Article 135 of *Regulations 33,* governing the administration of the 1913 law). The same regulations as revised to govern the administration of the 1916 law expressly included in such annual amortization the commissions and incidental expenses incurred in connection with bond issues (Article 150 of *Regulations 33 revised*). Subsequent regulations governing the later income tax laws

While the subsequent regulations have not contained express mention of commissions and incidental expenses, it has at all times continued to be the practice of the Bureau to amortize commissions and incidental expenses as well as discount (See Commissioner's brief, p. 4 and administrative rulings cited on p. 9 thereof).

Bureau made exception, however, and disallowed amortization if bonds were sold prior to 1909.

The general rule previously stated was however subject to an exception to the effect that such amortization would not be allowed in case the bonds had been sold prior to 1909 and the discount charged to income or profit and loss in the year of issue (*Treasury Decision* 2161, dated February 19, 1915, and Article 149 of *Regulations 33 revised*). This exception was based on the theory that the charging off of the entire discount in some year prior to the incidence of the Corporation Excise Tax Act of 1909, being the first income tax law, constituted a conclusive election to treat the discount as a closed transaction.

Board and Court overruled exception and recognized amortization of bond discount incurred prior to 1909.

The above stated position of the Bureau was at first sustained by the Board of Tax Appeals in *Western Maryland Railway Co.*, 12 B. T. A. 889, 907. That decision was, however, shortly thereafter overruled by the Board in *Chicago, Rock Island & Pacific Railway Co.*, 15 B. T. A. 988, 1027-1034, which held that the amortization of discount must be recognized equally whether the bonds were sold prior to the incidence of the income tax laws or thereafter and regardless of the taxpayer's method of accounting for the discount. *The Commissioner did not appeal.* The decision to the contrary in the *Western Maryland* case was reversed by the Circuit Court of

Appeals for the fourth circuit in 33 Fed. (2) 695, 696, and *the Commissioner did not seek certiorari.*

The Board has consistently followed its decision in the *Rock Island* case as to discount amortization (*Kansas City Southern Ry. Co.,* 16 B. T. A. 665, 686; *St. Louis Terminal Railroad Association,* 17 B. T. A. 1135, 1169; *Chicago & North Western Railway Co.,* 22 B. T. A. 1407, 1435). *No appeals have been taken by the Commissioner from any of those decisions as to the discount question.*

Board and Court, however, in Rock Island case distinguished expenses from discount and disallowed amortization of prior-to-1913 incidental expenses of bond issues.

The *Rock Island* case, *supra,* involving the question of prior-to-1913 discount, also involved among numerous other questions the question of amortization of incidental expenses of bond issues prior to 1913. The Commissioner, consistently with his then position as to the bond discount, denied the right to such amortization. The Board, although it had just held in the same opinion that prior-to-1913 discount was entitled to amortization, concluded that the incidental expenses of a bond issue differed from discount and sustained the contention of the Commissioner against the allowance of amortization of such incidental expenses. This decision was in deference to the decision of the Circuit Court of Appeals of the first circuit in *Commissioner* v. *Old Colony R. R. Co.,* 26 Fed. (2d) 408, against the taxation of annual amortization of premiums realized on prior-to-1913 bond issues.

This decision as to prior-to-1913 expenses was affirmed by the Circuit Court of Appeals for the seventh circuit in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner,* 47 Fed. (2d) 990, 991. The Rock Island petitioned for a writ of certiorari which was denied by this Court, 284 U. S. 618.

Thereupon the Bureau naturally sought to differentiate commissions from discount and disallow amortization of prior-to-1913 commissions as analogous to incidental expenses.

When the Bureau was defeated, as above shown, as to prior-to-1909 discount but was sustained as to prior-to-1913 incidental expenses there were pending some other railroad cases involving the question of amortization of prior-to-1909 bond discount. In an endeavor to salvage as much as possible out of the defeat on the discount question, the Bureau asserted in these cases a distinction between strict discount and commissions to bankers and underwriters and took the position that such commissions were ruled by that part of the decision in the *Rock Island* case, *supra,* against the amortization of prior-to-1913 expenses rather than by that part of the same decision in favor of the amortization of prior-to-1909 bond discount. The first case to come before the Board on this issue was that of the *Kansas City Southern Railway Co.,* 22 B. T. A. 949, 966. The Board decided without discussion that the amortization of prior-to-1913 commissions was not allowable, citing its decision as to the amortization of prior-to-1913 expenses in the *Rock Island* case.

When the Union Pacific Railroad Company's cases, out of which the present granted certiorari grows, came before the Board the Commissioner contested the allowance of commissions incurred prior to 1913, although conceding that the right to deduct amortization of discount, whenever incurred, was established (Board opinion, Tr., pp. 52-53). The Board disallowed the amortization of such commissions on the authority of its decisions against amortization of prior-to-1913 expenses in the *Rock Island* case, *supra,* and against the amortization of prior-to-1913 commissions in the *Kansas City Southern* case, *supra.* The Circuit Court of Appeals for the second circuit in the present case has reversed the Board on this point (Tr., pp. 101-103). The court below expressed the opinion that commissions should be dealt with on the same basis as discount. But its opinion did not rely wholly upon this reasoning. In other words, it was of the opinion that the recognition of the commission amortization could be sustained on broader grounds, which would appear to indicate that court's dissent from the result reached by the Circuit Court of Appeals of the seventh circuit in the *Rock Island* case as to the amortization of incidental expenses, although the opinion below does not expressly state such dissent.

It seems desirable to call attention to some inadvertent errors made in the Commissioner's brief in the statement of the Bureau's practice in the past, although the foregoing historical narrative necessarily corrects any statements in the Commissioner's brief which are in conflict

with statements in such narrative. On page 5 of the Commissioner's brief it is stated that: "As to premium "and discount on bonds issued before 1913 the Treasury "Regulations formerly authorized the amortization of both "premiums and discount." The quoted statement is incorrect as to prior-to-1913 *discount*. Article 149 of Regulations 33, revised, expressly excluded amortization of prior-to-1913 discount. And while the express exclusion was not continued in all later editions of the regulations, the practice continued the same until the decisions in the *Rock Island* and *Western Maryland* cases, *supra*, compelled the abandonment of that practice. In the footnote on pages 7 and 8 of the Commissioner's brief it is stated that: "the Commissioner in fact continued to permit tax-"payers to amortise and deduct commissions on bonds "issued prior to 1913 * * * until the decision of the "Board of Tax Appeals in *Chicago, R. I. & P. Ry. Co.* "case, 13 B. T. A. 988, 1034". This is wholly inaccurate. The Commissioner was denying the deduction of amortization of prior-to-1913 commissions as a part of discount until the decision in the *Rock Island* case sustained the right to deduction of amortization of the discount, and even thereafter the Commissioner has at all times sought to distinguish commissions from discount and has denied their deduction in the case of bonds issued prior to 1913. On Page 10 of the Commissioner's brief it is stated that: "Formerly the Treasury Regulations made no distinction "as to premiums and discount between bonds issued prior "to 1913 and those issued after that date". The regulations and the practice made a very substantial distinction in that the amortization of premiums was required until

this was held invalid by this court in the *Old Colony* case, 284 U. S. 552, while at all times the deduction of amortization of prior-to-1909 discount was denied until its recognition was required by the decision in the *Rock Island* case, *supra.*

ARGUMENT.

POINT I.

The Commissioner now asserts that bond commissions are wholly analogous to bond discount. This forecloses further argument, for the Board sustained in these same cases, with the acquiescence of the Commissioner, the deduction of amortization of the discount on the same bond issues and the Commissioner did not appeal.

We have shown in our narrative of the development of this controversy that the Commissioner has by a long course of conduct accepted decisions of the Board and Circuit Court of Appeals for the fourth circuit as establishing the right to amortization of prior-to-1913 discount. This was true notwithstanding the fact that at the time of the Board's first decision to this effect in the *Rock Island* case, 13 B. T. A. 988, 1027-1034, the Circuit Court of Appeals for the first circuit had held in the *Old Colony* litigation, 26 Fed. (2d) 408, that prior-to-1913 premiums were not taxable as current income in the form of amortization. The Board in its said decision discussed the *Old Colony* decision and concluded that it had

no bearing on the discount question (13 B. T. A. at 1029). The Commissioner failed to take an appeal from the decision of the Board in the *Rock Island* case. He omitted to apply for certiorari to review the same decision of the Circuit Court of Appeals for the fourth circuit in the *Western Maryland case,* 33 Fed. (2d) 695, 696. He omitted any appeal on this point from a number of subsequent decisions by the Board. His brief in this case at page 12 states that he did not raise the discount question in *New York, Chicago & St. Louis R. R. Co.* v. *Burnet,* 64 Fed. (2d) 152, 154, in the Court of Appeals for the District of Columbia. It is evident, however, that a hope has been entertained in the Bureau of Internal Revenue that by some reasoning this court's decision in the *Old Colony* case, 284 U. S. 552, might be used as a means of upsetting the very formidable body of decisions sustaining the right of deduction of prior-to-1913 discount amortization, for the government sought to raise the question in *Tait* v. *Western Maryland,* 62 Fed. (2d) 933, in the fourth circuit but was precluded by a plea of *res adjudicata.* The Commissioner's brief in the present case states at page 12 that the government abandoned the question of bond discount in *Tait* v. *Western Maryland* when that case was presented to this court, 289 U. S. 620.

The present cases involved claims for the deduction of discount amortization as well as claims for the amortization of commissions on the same three bond issues made prior to 1909. The Board allowed the claims for amortization of discount amounting to $251,000 in each of the

tax years, while disallowing the claims for deduction of commission amortization amounting to $57,000, and stated in the opinion that counsel for the Commissioner conceded that the prior decision of the Board in the *Rock Island* case decided the discount question adversely to him (Tr. pp. 52 and 53). The Commissioner took no appeal from the Board's decision allowing the discount amortization. Therefore the right of the respondent to the deduction of the discount amortization claimed in these cases is conclusively established.

We understand the Commissioner's case before this Court to be based on his assertion that commissions are wholly analogous to discount and premiums. The analogy of discount, premiums and commissions is twice stated on page 5. On page 10 is stated the belief that "premiums, "as well as discount and commissions, are all similar and "should all be treated alike". On pages 13 and 14 it is said: "The Commissioner's action (as to the treatment "in this case of some of the commissions as a part of the "discount) amounts to a tacit admission that the distinc- "tion between commissions and discounts is tenuous and "elusive". Again on page 15 it is said: "However, prem- "iums, discounts, commissions, and incidental expenses "all stand on the same footing". In other words, the Commissioner stakes his whole case on the hope of persuading this Court that the reasoning of its decision in the *Old Colony* case, 284 U. S. 552, as to prior-to-1913 premiums is equally applicable to prior-to-1913 discount and commissions. That contention may be available to the Commissioner in some other case but it does

not seem that in this case, in which the right to deduction of discount has become *res adjudicata,* it is open to the Commissioner to assert that prior-to-1913 discount is not entitled to tax deduction and that the deduction of prior-to-1913 commissions must also be excluded because of their complete analogy to bond discount.

POINT II.

But, if the Commissioner's argument is not foreclosed, we agree that the analogy between commissions and discount is complete, but submit that the reasoning of the decision in the Old Colony case, 284 U. S. 552, has no application to the question of amortization of discount and commissions.

When this case was before the Board and before the Circuit Court of Appeals it was the position of the Commissioner that commissions should be distinguished from strict discount and classified with incidental expenses so that he might invoke the application of the decision of the Circuit Court of Appeals for the seventh circuit in the *Rock Island* case, 47 Fed. (2d) 990, 991, denying amortization to prior-to-1913 incidental expenses. In fact this view continued to be entertained until and including the preparation of the petition for certiorari in this case, for that petition is based upon an alleged conflict of decisions. The decision below in this case was asserted to be in conflict with the decision in the seventh circuit as to incidental expenses.

The court below, as one but not the sole ground of its decision, sustained our contention that there is a complete analogy between strict discount and commissions. In view of the Commissioner's present agreement to that proposition, it is evidently not necessary to argue it, but we, nevertheless, submit the following demonstration of the proposition.

There is no justification for drawing a distinction between the commissions involved in this case and the strict discount. From the standpoint of the issuing corporation the discount and the commissions are indistinguishable. If the corporation retains bankers to sell for its account an issue of bonds at 96 with an undertaking to pay the bankers a two per cent. commission, the corporation realizes only a net amount of 94 as the new capital it sought and the cost of that new capital is the sum of the discount and the commission, namely, six per cent. of the face value of the issue. The result is precisely the same if the bankers purchase the bonds outright at 94 and resell them for their own account to the public at 96. If bonds are offered to the public at 96 with a syndicate underwriting at a two per cent. commission, the net amount of 94 is the new capital realized by the corporation and the cost of that new capital is six per cent. of the face value of the issue; and this is equally true whether the bonds are purchased by the public or by the underwriting syndicate. In the several foregoing examples six per cent. of the face value, representing the cost of securing the use of the new capital, will stand throughout the life of the bonds as a liability which must be met at the maturity of the bonds and which should therefore be amortized over the

life of the bonds and taken as deductions annually and ratably. There is no possible justification for a different treatment for tax purposes of any of the above suggested transactions.

The distinction which the Board, at the instance of the Commissioner, has made in the case of bond commissions depends wholly upon giving controlling importance to the identity of the persons who received the benefit of the commissions or the discount as the case may be. If that benefit went to the purchasers of the bonds, it is treated as discount and its amortization is allowed, even though the transaction occurred before 1913. If the benefit went to other persons than the purchasers of the bonds, it is treated as a commission and in that case the amortization is not allowed because the transaction occurred prior to 1913. Indeed, in the present case in the two instances in which the underwriters were themselves required to take up the bonds, the taxpayer has been allowed the amortization of both the discount and the underwriters' commission, although the transaction was prior to 1913; but in those instances in which the underwriters earned their commission without taking up the bonds, the amortization of their commission has not been allowed because the transactions occurred prior to 1913. The *bankers'* commissions upon all three issues of bonds involved in the present case have been disallowed amortization, because the issues were prior to 1913, although if the bankers had bought the bonds outright, at prices representing the net amount realized by the issuing corporations after the deduction of commissions, amortization would have been allowed. It is obvious that the identity of the persons receiving the benefit of any allowance from the face

value of the bonds or from the proceeds is not a consideration which should control the question of the right of the corporation to deduct amortization. It is the issuing corporation's tax liability which is concerned, and the question of the deduction of amortization should be determined by the effect on the issuing corporation of the benefits it has allowed in connection with the issue of its bonds. The effect upon the issuing corporation is the same whether the cost which it has incurred is called "discount" or "commission"; it is the same whether, if called "commission", it went to an underwriter who was obliged to take up the bonds and so obtained the benefit also of the discount, or to an underwriter who was not obliged to take up the bonds and therefore had the benefit only of the commission.

The foregoing discussion demonstrates, we submit, that bond discount and commissions to underwriters and bankers in connection with the issuing of bonds, are indistinguishable from the standpoint of the issuing corporation and must be accorded the same treatment for tax purposes. Since, in the present case and under the decisions hereinbefore cited, the amortization of discount is allowed as a current deduction, even though the bonds were sold prior to 1913, it must follow that amortization of the commissions incurred on the same bonds prior to 1913 is entitled to allowance as a deduction in the current years.

In the *Rock Island* litigation the decisions of both the Board and the Circuit Court of Appeals for the seventh circuit rested the denial of amortization of prior-to-1913 incidental expenses upon an assumed analogy to the holding in *Commissioner* v. *Old Colony R. R. Co.*,

26 Fed. (2d) 408, by the Circuit Court of Appeals for the first circuit that premiums realized on a bond issue prior to 1913 are not taxable as income in the form of current amortization. This decision in the first circuit was afterward confirmed by this Court in a later litigation by the *Old Colony R. R. Co.*, 284 U. S. 552, to which we shall refer further under another point. The reasoning of the Circuit Court of Appeals for the first circuit, which was adopted by the Board and the Circuit Court of Appeals for the seventh circuit in denying amortization of prior-to-1913 incidental expenses, was that the premium realized on the sale of bonds was received by the corporation prior to the adoption of the Sixteenth Amendment and so had become capital prior to the adoption of that amendment and could not be reached by the subsequent income tax laws through the device of amortization. There is, however, no constitutional problem concerning the allowance of deductions from income. Deductions are wholly a matter of statute and as to them Congress is not controlled by any constitutional restriction. On the prior-to-1913 discount question involved in the same *Rock Island* case the analogy of the principle of the decision in the *Old Colony* case was urged but was rejected, the Board saying (13 B. T. A. at 1029):

> "What is income is controlled by the Constitution, "while deductions are a statutory concept. In the "years before us, the petitioner was on an accrual "basis for the reporting of income, not only because "that was the system necessary to reflect true in- "come, but because the Interstate Commerce Commis-

> "sion required such a basis. Income realized before "the adoption of the Sixteenth Amendment may not "thereafter be taxed, but as concerns deductions from "income, the same rule does not necessarily apply. "In the case of a continuing transaction, even though "it had its inception prior to February 25, 1913, there "may arise statutory deductions from income which "a taxpayer is not deprived of by reason of the "date of the enactment of the Sixteenth Amendment".

The above quoted language of the Board is as complete an answer in the case of commissions and expenses as in the case of discount to the claimed analogy of the principle of the *Old Colony* decision.

We do not accept as sound the decision of the Board or the decision of the Circuit Court of Appeals for the seventh circuit in the *Rock Island* case as to prior-to-1913 incidental expenses. It is not consistent to allow and require the amortization of such incidental expenses incurred after 1913 and at the same time to disallow the amortization of identical expenses incurred prior to 1913. But we do not wish to encumber this argument with a discussion of the proper status for tax purposes of incidental expenses. The question of the amortization of commissions can stand on its own feet. The question of what expenditures call for amortization necessarily involves some discretion and therefore requires that the line be drawn somewhere. It might well be sound to deny amortization to the incidental expenses of a bond issue because of their lesser importance in the exercise of discretion. This Court in denying certiorari on this question in the *Rock Island* case (284 U. S. 618) may have been influenced by this consideration.

POINT III.

Commissions, like discount, inherently represent allowances or payments as a part of the cost of conducting the corporate business in future years, and by reason of this inherent nature their amortization for tax purposes is required by the uniform practice.

Some confusion of thought is evidenced in the decisions, on the question of amortization of commissions and similar allowances or payments, which appears to be due to the separate treatment in the income tax laws of the various items making up the whole cost of doing business. Separate paragraphs authorize the deduction of ordinary and necessary expenses, of interest, of depreciation and exhaustion, of losses and of other items of cost not here material. The question is simplified if it is borne in mind that only that portion of any item of cost of doing business which is properly applicable to the tax year is chargeable against the income of that year, regardless of when it was paid and regardless of the classification of the item of cost among the various deduction paragraphs. If a payment is made in advance which is clearly applicable to future years, or if a liability is incurred which is clearly applicable to years prior to its maturity, amortization is essential in order to reflect correctly the income of the several tax years. This is the underlying principle of amortization. A taxpayer using the "cash" basis of accounting will probably not actually keep an amortiza-

tion account as to any item of cost. A taxpayer using the "accrual" basis may charge off a payment or a liability once for all in the year in which it is made or incurred. But, subject to some latitude in the case of items of minor importance where the taxpayer is on the "cash" basis, it is the practice of the Bureau, with the acquiescence of the taxpayers generally, to insist upon the observance of the amortization principle regardless of the taxpayer's accounting basis and regardless of the bookkeeping adopted by the taxpayer in the particular instance.

Both the Revenue Act of 1918 and the Revenue Act of 1921, which govern the present cases, include in the definitions under Section 200 the following: "The term "'paid' for the purposes of the deductions and credits "under this title, means 'paid or accrued' or 'paid or "incurred'," etc. All the other income tax laws, beginning with that of 1916, have contained the same provision in substance. Such provisions have constituted the authority under which the Bureau has applied the amortization principle.

The amortization principle as we have shown in the narrative of the development of the controversy has been applied uniformly to discount, commissions and incidental expenses of bond issues made after March 1, 1913.

Again, in the case not only of commissions for securing loans or selling bonds but also of commissions or bonuses for securing leases or other long term contracts, the deduction of the whole payment in one year is denied on the

ground that it is a part of the cost of the loan or lease or other contract which should be spread over the life of the loan or lease or contract and the proper amortization taken as an annual deduction. In *Emerson Electric Manufacturing Co.,* 3 B. T. A. 932, the Board referred to the principle governing commissions on bond issues as follows:

> "Further, it is clear to us that the revenue of a "day or a year should not be burdened with the cost of "acquiring additional capital, the benefits from which "will inure to the corporation over a long period of "years. This is the doctrine generally recognized and "adopted in the treatment of expenses incident to the "procuring of temporary capital through the flotation "of bonds and other term securities, and in such "cases the expenses are written off over the life of the "indebtedness".

In the *Rock Island* case, *supra,* in considering the question of incidental expenses incurred *after* March 1, 1913, the Board said (13 B. T. A., at p. 1035) that it was not impressed by the contention of the Commissioner that there was a distinction between discount and incidental expenses of issuing bonds, and further:

> "While such expenses do not so nearly coincide with "the concept of interest, they are, nevertheless, in- "timately connected with the loan and in fact con- "stitute a part of the cost of the money borrowed. "We see no reason for divorcing them from the loan "and holding them annual expenses".

See *S. & L. Building Corporation* case, 19 B. T. A. 788, 795, concerning commissions for securing a mortgage

loan on real estate, and *Bonwit, Teller & Co.* case, 17 B. T. A. 1019, 1024, concerning brokerage fees paid for securing a lease.

The same principle has been applied to require the amortization of cost of patents, copyrights, licenses or franchises (Art. 163 of Regulations 62, and *Hershey Manufacturing Co.* v. *Commissioner,* 43 Fed. (2d) 298), and the cost of baseball players' contracts (*Houston Baseball Assn.* v. *Commissioner,* 24 B. T. A. 69) and the purchase of an insurance agency contract (*Flynn, Harrison & Conroy,* 21 B. T. A. 285).

The cost of improvements on leased property which improvements will revert to the lessor at the end of the term constitute another class of expenditures the amortization of which is allowed. See *Kunkel & Co.,* 3 B. T. A. 133, 138-9. *Strand Amusement Co.,* 3 B. T. A. 770, 776. *Solicitors Recommendation* 2499 (IV-1 Cumulative Bulletin, p. 142).

The Commissioner and the Board have consistently applied the theory that such payments or allowances as the foregoing, concerning as they do the acquisition of something which benefits the taxpayer over a defined period, as distinguished from payments and allowances which exhaust their usefulness in the year when made, represent cost of the benefit for the full period of its life which can be taken as a tax deduction only in the form of amortization.

There is therefore no question in this case that the commissions involved are of such an inherent character as to be subject to the principle requiring amortization.

POINT IV.

Since both discount and commissions are subject to amortization, the annual amortization thereof applicable to the tax years under review must be allowed deduction under some name as constituting an item of cost of the business for those years, and the fact that they were incurred prior to 1913 is immaterial.

There are several classes of deductions authorized by the tax laws which may be considered applicable.

Deduction as Interest:

The allowance of amortization of bond discount has been rested on the reasoning that the discount constitutes deferred interest to be paid at maturity in addition to the nominal rate of interest currently paid during the life of the bonds. In the *Rock Island* case, the Board said (13 B. T. A. 1031):

> "It is significant that they (the official regulations) "are in harmony with general accounting practice, "which treats discount as deferred interest to be "spread over the life of the obligation."

and again at page 1033:

> "We are of opinion that in an economic and "accounting sense, the discounts, herein involved, "are in the nature of deferred interest, that they "may be accrued and that the proper proportionate "part applicable to each taxable year involved may "be taken as a deduction from gross income in such "year" etc.

By the same reasoning the commissions paid in connection with a bond issue constitute interest additional to the nominal rate carried by the bonds. This is so whether the commissions are to be considered fully equivalent to discount and therefore, like the discount, represented by a liability to be met at maturity, or be considered, unlike discount, as a payment made in advance as a part of the cost of obtaining the use of the new capital. In the one case the payment of the additional interest is deemed deferred to be paid at maturity; in the other case the additional interest is paid in advance. In either case amortization is necessary to reflect correctly over the life of the bonds the cost of the use of the borrowed money.

The Board has not, we believe, discussed in any discount question before it the question whether the deduction of the amortization is authorized specifically as an interest deduction or is to be recognized under some other classification of deductions. In both the Revenue Acts of 1918 and 1921 the allowable deductions for corporations were listed in Sec. 234(a) and paragraph (2) thereof specified:

> "(2) All interest paid or accrued within the taxable "year on its indebtedness",

there following an exception not here material. That specification may or may not be deemed entirely appropriate as express authority for the deduction of the additional interest represented by discount and commissions. It is unnecessary to discuss or determine that point, for there is no room for doubt that some one or more of the

specified classes of allowable deductions must cover such additional interest, so that, if the authority is not deemed to reside in the interest-deduction paragraph, it will certainly be found in some other deduction paragraph. The income tax laws have from the beginning embodied a very liberal policy as to the deductions allowed corporations. The policy has not been equally liberal in the case of individuals, who have not been allowed to deduct personal or living expenses or losses incurred in transactions not entered into for the purpose of profit. But the deductions allowed corporations, taken as a whole, evidence a broad intention and policy to allow the corporation to deduct under one name or another the entire cost of conducting its business.

The Commissioner does not refer, as we had supposed he would, to a second point decided by this Court in the *Old Colony* case, 284 U. S. 552. In that case the Commissioner, having been defeated in the earlier litigation [26 Fed. (2d) 408] on the question of his treatment of the amortized premium as income, urged that his result could be sustained by regarding his treatment of the amortized premiums as merely an offset against the nominal interest paid, for the purpose of determining the true net interest cost and limiting the taxpayer's deduction thereto. The Circuit Court of Appeals for the first circuit had in this later litigation adopted the new theory of the Commissioner [50 Fed. (2d) 896]. This Court, however, rejected the theory and held (p. 560) that Congress must be deemed to have used the word "interest" in the paragraph recognizing interest

as a deduction in the ordinary signification of the word. Accordingly it held that the taxpayer was entitled to the deduction of the full interest currently paid by it on its bonds, without the offsetting against such interest of the amortized premium. So we had supposed it would be urged here that on the same reasoning the interest deduction paragraph does not permit the deduction of something *in addition* to the nominal rate of interest paid on the bonds. It is, however, one thing to deny a taxpayer the deduction of the interest actually paid in the face of an express statutory authority for the deduction of the full interest payment, and it is quite another thing to hold that the statutory authority to deduct "all interest paid or accrued" is not elastic enough to embrace an additional cost of the taxpayer's borrowed money over and above the rate of interest nominally carried by the bonds. But again we say that it is not necessary to determine the question of the sufficiency of the interest-deduction paragraph to include the amortized discount and commissions, in view of other authorized classes of deductions which are readily applicable to such additional interest even if the specific interest-deduction paragraph is not considered applicable.

In conclusion under this heading we submit that it is not open to doubt that, if the amortized discount and commissions are entitled to deduction *as interest,* either deferred or paid in advance, they represent the part of the cost of the borrowed money applicable to the tax years in question, and that, even if this cost be considered as paid prior to 1913, it does not represent an *expense incurred for the period prior to 1913.*

Deduction as a loss:

In both the Revenue Acts of 1918 and 1921 the deduction of losses was authorized by paragraph (4) of Section 234(a) reading as follows:

> "(4) Losses sustained during the taxable year "and not compensated for by insurance or otherwise".

Regulations 33 (revised) adopted to govern the administration of the income tax law of 1916 provided in Article 150 as follows:

> "In cases wherein a corporation sells its bonds at "a discount plus a commission for selling, the amount "of such discount and commission, together with other "expenses incidental to issuing the bonds, constitutes "a loss, the aggregate amount of which loss will, for "the purpose of an income tax return, be prorated "over the life of the bonds sold, and the amount thus "apportioned to each year will be deductible from 'the gross income of each such year until the bonds "shall have been redeemed".

It will be noted that the above quoted article characterized the discount, commissions and expenses of a bond issue all as a *loss*. The official regulations issued under the later revisions of the income tax law have all contained a corresponding article providing for the amortization of discount, but without characterizing it in any way. We know of nothing, however, which indicates any change in the Bureau's view that discount, commissions and expenses constitute a loss to be amortized and deducted under the authority of paragraph (4) above cited. The

propriety of allowing the deduction of amortized discount, commissions and expenses under one or another of the paragraphs of the deduction section has simply been so universally accepted that it has not been necessary for either the Board or the Bureau to determine specifically which paragraph should be invoked.

Presumably the view that discount and commissions constitute a loss incurred on a bond issue rests upon the theory that the new capital obtained on the bond issue is the net amount of the proceeds realized, and that therefore the commissions equally with the discount are represented by a liability to be met at the maturity of the bonds. Under this view the amortization during the life of the bonds is in anticipation of the payment of the liability. Obviously under this view the annual amortization of the discount and commissions applicable to any tax years after 1913 represents an item of the cost of doing business in those years, although the loss will not become a completed transaction until the liability is met at maturity. *On this theory there is involved no expense incurred for any period prior to 1913.*

Deduction as exhaustion:

The case of *Julia Stow Lovejoy*, 18 B. T. A. 1179, involved the deduction of a commission paid to bankers for securing a loan which invokes the paragraph authorizing deduction for depreciation, exhaustion and obsolescence as the authority for the deduction of the amortized commission. The taxpayer was an individual and the loan was obtained for her business

purposes upon her mortgage notes. The Board sustained the Bureau's refusal to allow the deduction of the entire commission in the year in which it was incurred and held that it was an inherent cost of financing. The Board said at page 1182:

> "The result of this disbursement was that peti-
> "tioner had for ten or fifteen years the use of
> "another's money as the basis of deriving income.
> "Presumably, she believed, when she incurred these
> "items of cost and paid them, that she would secure
> "income enough to enable her to pay interest on the
> "loan and recoup these initial payments either out
> "of income or ultimate sale. The reasonableness of
> "such a supposition persists even if in the science
> "of accounting there were no device for recording the
> "continuing effect of the payment. That ordinarily
> "such a payment is not reflected among the assets of
> "a balance sheet is not controlling. If, notwithstand-
> "ing petitioner's so-called cash basis, she had pre-
> "pared a balance sheet and had included in her assets
> "this item by whatsoever designation so long as it
> "disclosed the facts, such a schedule would have been
> "beyond reproach.
>
> "In its essence such a disbursement is not unlike
> "bond discount, prepaid rent, cost of acquiring or
> "disposing of a leasehold or term contract and many
> "other transactions. They should be spread over the
> definite period of the loan, lease, or contract. * * *
> "This is on the theory that they result in property
> "of a sort and its cost is being exhausted propor-
> "tionately over a period of years and should be pro-
> "vided for on the basis of time, production, or other-
> "wise. Sec. 214 (a)(8)."

In the *Lovejoy* case above quoted the Board encountered some difficulty because of the fact that the taxpayer kept her accounts on a cash receipts and disbursements basis which would not have been present in the case of a taxpayer on the "accrual" basis of accounting. But the principle applies under either method of accounting. The principle is that the payment of commissions to bankers or underwriters for disposing of a new bond issue, or any comparable payment, in effect creates an intangible asset which may legitimately be set up on the asset side of the balance sheet as a payment made for the account of future years and which is subject to exhaustion charges in each subsequent year, such exhaustion charges being legitimate annual deductions for income tax purposes.

The reference at the end of the above quotation from the *Lovejoy* case to Section 214 (a)(8) as the paragraph of the law under which the deduction is authorized is a reference to the Revenue Act of 1924 which was applicable to that case. The paragraph cited concerned the deductions to which individual taxpayers are entitled. It read as follows:

> "(8) A reasonable allowance for the exhaus-
> "tion, wear and tear of property used in the trade
> "or business, including a reasonable allowance for
> "obsolescence."

In the 1924 Act Section 234 covered the deductions allowed to corporations which contained as paragraph (7) the identical language above quoted. The Revenue Acts of 1918 and 1921 which govern the present case contained

the deductions allowed to corporation taxpayers in Section 234 and in each act paragraph (a)(7) of that section authorized deductions for exhaustion, wear, tear and obsolescence in the same language as that above quoted from the 1924 Act.

Considering a commission payment as creating an intangible asset subject to exhaustion, no difficulty arises because of the fact that the commission was paid prior to the incidence of the income tax laws. Upon the incidence of the income tax laws the asset account will have been reduced by the charges for exhaustion during the prior period, but the balance of cost remaining unexhausted will stand as an asset subject to further appropriate exhaustion charges in the future years. Such charges made for exhaustion in the subsequent years constitute a part of the cost of doing business in those years.

There would be no more justification for disallowing the deductions for such current exhaustion on the ground that the cost had been paid prior to the incidence of the income tax laws than there would be justification for denying the deduction of depreciation after 1913 of the cost of a factory because such cost had been paid and the investment made prior to 1913.

Deduction as an ordinary and necessary expense:

Generally the cases involving commissions for securing loans and commissions and bonuses for securing leases, etc. arise because of the taxpayer's claim to deduct the entire amount of the commission or bonus in the year in which it was paid. The Board in rejecting such claims

and requiring amortization of the amount has frequently expressed the ground of its decision as being that the payments are not "ordinary and necessary expenses" in carrying on a trade or business but are a "cost" of the loan or lease which should be spread over the period during which the taxpayer enjoys the benefit of the transaction. We think the Board has unnecessarily denied to such commissions the character of ordinary and necessary expenses and has sought a different label because of an imaginary difficulty about otherwise denying the right to deduct the entire commission in the year in which it was actually paid. There is no apparent reason why either discount or commissions amortized over the years to which they apply may not be justified as ordinary and necessary expenses of those years. The Board is clearly in error if it thinks that the question whether an expenditure is deductible in one year or should be amortized can be determined by the particular name or classification which it assigns to the item.

It is bookkeeping of the most common occurrence to amortize ordinary and necessary expenses, although usually only over a short period. A very familiar and everyday example of this practice is involved in the payment of fire insurance premiums for several years in advance. Such proportion of the payment as is applicable to the years subsequent to the year of payment should be charged to the proper expense account of the subsequent years as those years are reached, and in the meantime should appear as a "suspense" item. In other words, an advance payment for something belonging to future years should not be charged as an expense of the year

in which the payment is made and, until it can properly be finally charged out, it may be booked as a suspense item on the asset side of the accounts. Whatever the actual bookkeeping, it is in effect an asset, since it takes the place of the cash expended and is as good as cash in that it has reduced the actual disbursements necessary to be made for the cost of doing business in the subsequent years.

Again it is not uncommon for rent to be paid for one year or more in advance. The treatment of such advance payments for tax purposes would be identical with that of the payment of insurance in advance above discussed. The advance payment of rent bears a very close analogy to commissions in connection with a bond issue. The commission, as has been stated, represents a part of the cost of the use of the borrowed money. As such it could appropriately be denominated "rent" paid for the use of the money.

In both the Revenue Acts of 1918 and 1921 the deduction by corporations of ordinary and necessary expenses of the business are authorized under Sec. 234(a) by paragraph (1) thereof as follows:

> "(1) All the ordinary and necessary expenses paid "or incurred during the taxable year in carrying on "any trade or business, including a reasonable allow- "ance for salaries or other compensation for personal "services actually rendered, and including rentals or "other payments required to be made as a condition "to the continued use or possession of property to "which the corporation has not taken or is not taking "title, or in which it has no equity."

Throughout the administration of the income tax laws the paragraph authorizing the deduction of ordinary and necessary expenses has been administered in a very liberal way. No narrow interpretation of the words "ordinary" or "necessary" has been adopted. As a few examples of payments which under an interpretation having any narrow tendency might have been considered "extraordinary" rather than "ordinary": A lessee executing a lease, to become effective two years later, paid $200,000 to cover losses which the lessor feared might be suffered during the intervening two years through removals of existing tenants or reduction of existing rentals, and this payment was allowed as an ordinary and necessary expense of the lessee, although required to be amortized over the life of the lease (*Saks & Co.,* 20 B. T. A. 1151). A heavy expense of defending a patent litigation was allowed (*F. Meyer & Bro. Co.,* 4 B. T. A. 481). Attorneys fees and expenses of some $162,000 incurred by an individual in the successful defense of his prosecution for conspiracy to defraud the United States in the matter of taxes of the corporation of which he was chief executive were allowed as his ordinary and necessary expenses (*Peoples-Pittsburgh Trust Co., et al. Executors,* 21 B. T. A. 588). The cost of an automobile given every six months by a corporation operating restaurants as a prize to be drawn by lot by its customers was allowed as a business expense (I. T. 1667; II-1 Cumulative Bulletin 83). A cost of $1,000,000 incurred by the Association of Railway Executives in an advertising campaign at the end of Federal control of the

railroads for the improvement of the attitude of the public toward the railroads, shared proportionately by the railroad corporations members of the association, was allowed deduction by them respectively as a business expense (*Los Angeles & Salt Lake R. R. Co.,* 18 B. T. A. 168).

A recent opinion of the general counsel of the Bureau of Internal Revenue (General Counsel's Memorandum 13148 dated June 18, 1934) upholding the amortization under all income tax laws beginning with that of 1918 of insurance premiums paid in advance for a period of more than one year is very pertinent to this discussion and it is printed in full as an appendix to our answer to the petition for certiorari herein.

The foregoing miscellaneous examples show that such amortized discount and commissions could readily be justified as a deduction as an "ordinary and necessary expense" of the corporate business. It would seem quite unnecessary to go further afield and invoke the authority for deduction of interest, or of losses, or of exhaustion of cost of property.

Considering bond discount and commissions as an ordinary and necessary expense, no difficulty arises as to the allowance of their amortization in the current tax years because of the fact that they were incurred prior to the incidence of the tax laws. The unamortized portion of the discount and commissions remaining upon the incidence of the income tax laws represents expenses incurred as a part of the cost of the business for the future tax years,

to be charged as expenses of those years as they arrive, and cannot be disallowed as expenses incurred for the period prior to the incidence of the income tax laws.

CONCLUSION.

The decision below should be affirmed.

Respectfully submitted,

HENRY W. CLARK,
Counsel for Respondent,
120 Broadway,
New York City.

October 31, 1934.

SUPREME COURT OF THE UNITED STATES.

No. 51.—October Term, 1934.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Union Pacific Railroad Company.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[December 3, 1934.]

Mr. Justice Stone delivered the opinion of the Court.

Prior to 1913 respondent, directly or through a subsidiary corporation, sold three issues of bonds, all maturing at dates subsequent to 1923. All were sold at a discount and petitioner paid or allowed to bankers an additional amount as commissions for marketing the bonds. The commissions and discounts, amortized over the periods from the dates of issue to maturity of the bonds, exceeded $300,000 in each of its taxable years 1918 to 1923 inclusive. Respondent kept its books and made its tax returns on the accrual basis. Deduction from gross income, in its tax returns, of the amortized amount of the commissions and discount was disallowed by the Commissioner, who found a corresponding deficiency under the applicable Revenue Acts of 1918, c. 18, 40 Stat. 1057, and 1921, c. 136, 42 Stat. 227.

The Board of Tax Appeals ruled that the petitioner was entitled to the deduction for the discount but not commissions. 26 B. T. A. 1126. On the appeal of the taxpayer alone the Court of Appeals for the Second Circuit reversed the Board, holding that the commissions should be treated in the same manner as the discount and that the deductions were rightly made. 69 F. (2d) 67. This Court granted certiorari, 293 U. S. —, on the petition of the Commissioner, which set up that the decision below conflicted with that of the Court of Appeals in the Seventh Circuit, in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner,* 47 F. (2d) 990, see also *Bonded Mortgage Co.* v. *Commissioner,* 70 F. (2d) 341, and is inconsistent with the decision of this Court in *Old Colony Rail-*

road Co. v. *Commissioner*, 284 U. S. 552, which held that premiums received by the taxpayer upon the sale of its bonds before 1913 could not be subjected to income tax in later years by the expedient of prorating them over the period between the date of issue of the bonds and their maturity.

In support of its petition the Government contends that the commissions are not, as the court below held, losses incurred in the taxable year which are deductible under § 234 (a) (4) of the Revenue Acts of 1918 and 1921, although not to be realized until payment of the bonds at maturity. It insists instead that the commissions are expenses incurred and paid at the date of the bond issue which cannot, on any theory, be deducted in later years. Further, it contends that the amortization of the commissions paid before 1913 and their deduction as amortized in tax returns in later years is inconsistent with the decision of this Court in *Old Colony Railroad Company* v. *Commissioner, supra.*

1. There is no provision in either the 1918 or 1921 Revenue Acts specifically authorizing the deduction from gross income of commissions or discount paid or allowed by the taxpayer upon an issue of bonds. Section 234 of the 1918 and 1921 Acts, like the corresponding provisions of the Acts before and since, allow deduction of expenses paid or incurred, interest paid or accrued, and losses sustained during the taxable year. Section 212 (b) and 213 (a) of the 1918 and 1921 Acts, like § 13 (d) of the 1916 Act, c. 463, 39 Stat. 756, 771, authorize the taxpayer to make his income tax returns on the accrual basis where his books are kept on that basis and reflect true income; they require it if he fails or is unable to make his return on a cash receipts and disbursements basis. The taxpayer is thus enabled to charge against income of the taxable period expenses incurred in and properly attributable to the process of earning income during that period, although payable in a later one. See *United States* v. *Anderson*, 269 U. S. 422, 440; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92; *Miles Bement Pond Co.* v. *United States*, 281 U. S. 357. It follows that when the return is made on the accrual basis, expenses or obligations incurred by the taxpayer in connection with a bond issue, which are not discharged until the payment of the bonds at maturity, may properly be accrued or amortized over the period of the life of the bonds and allowed as annual deductions from gross income.

By Article 150, Treasury Regulations 33, as revised, relating to the 1916 Revenue Act, both commissions and discount upon bond issues of the taxpayer were classified as losses sustained on payment of the bonds at maturity, and taxpayers were permitted to amortize them over the life of the bonds and deduct them as amortized from gross income in each year. These regulations were continued under the 1918 and 1921 Acts, but the reference to commissions was omitted.[1] Art. 544 of T. R. 45; Art. 545 of T. R. 62. The Board of Tax Appeals has consistently applied the regulations as to bond discount allowed before 1913 and in each case, as in the present, the Government, by failing to seek review of the ruling, has acquiesced in it.[2]

Both commissions and discount, as the Government concedes, are factors in arriving at the actual amount of interest paid for the use of capital procured by a bond issue. The difference between the capital realized by the issue and par value, which is to be paid at maturity, must be added to the aggregate coupon payments in order to arrive at the total interest paid. Both discount

[1]Notwithstanding this change in the regulations, the Commissioner appears to have continued to permit taxpayers to amortize and deduct commissions paid on bond issues prior to 1913, as the regulations under the 1916 Act had expressly permitted. A change of practice was sanctioned in Chicago, Rock Island & Pacific Ry. Co. *v.* Commissioner, 13 B. T. A. 988, 1034, affirmed by the Court of Appeals of the Seventh Circuit, 47 F. (2d) 990, 991, where the taxpayer, while allowed to deduct bond discount, was not allowed to deduct from gross income the amortized expenses of a bond issue incurred before 1913. This refusal to allow amortization of commissions was confined to the case of bonds issued before 1913.

Treasury regulations have also been silent as to commissions on bonds issued after that date. Art. 544 of T. R. 45; Art. 545 of T. R. 62, 65, 69; Art. 68 of T. R. 75, 77. But there are a number of Treasury rulings which permit the amortization of commissions on bonds issued after 1913. O. D. 936, 4 Cum. Bul. 276; O. D. 959, 4 Cum. Bul. 129; I. T. 1412, I-2 Cum. Bul. 91; I. T. 1962, III-1 Cum. Bul. 291; S. M. 3691, IV-1 Cum. Bul. 145.

[2]Chicago, Rock Island & Pacific Co. *v.* Commissioner, 13 B. T. A. 988, 1027-1034; Kansas City Southern Ry. Co. *v.* Commissioner, 16 B. T. A. 665, 686; Terminal Railroad Ass'n of St. Louis *v.* Commissioner, 17 B. T. A. 1135, 1169; Chicago & Northwestern Ry. Co. *v.* Commissioner, 22 B. T. A. 1407, 1435. In one case the Board refused to allow the amortization, on the theory that the bonds were issued not by the taxpayer but by a predecessor corporation. Western Maryland Ry. Co. *v.* Commissioner, 12 B. T. A. 889, 907. On appeal by the taxpayer the Board was reversed. 33 F. (2d) 695, 697 (C. C. A. 4th). The Government did not seek review.

and commissions are included in this difference. If the difference be viewed as a loss resulting from the funding operation, it is one which is realized only upon the payment of the bonds at maturity.

But even if the commissions, unlike discount, may, as the Government insists, be regarded as a contemporary expense of procuring capital, it is one properly chargeable to capital account. In practice it is taken out of the proceeds of the bonds by the banker. But in any case it must be deducted from the selling price to arrive at the capital realized by the taxpayer from the sale of the bonds, in return for which he must, at maturity, pay the face value of the bonds. The effect of the transaction in reducing the capital realized, whether through the payment of commissions or the allowance of discount, is the same. In this respect the commissions do not differ from brokerage commissions paid upon the purchase or sale of property. The regulations have consistently treated such commissions, not as items of current expense, but as additions to the cost of the property or deductions from the proceeds of sale, in arriving at net capital profit or loss for purposes of computing the tax.[3]

Here the commissions, when paid, were properly chargeable against capital, and reduced by their amount the capital realized

[3]Art. 8 of T. R. 33, revised; Art. 293 of T. R. 45, 62; Art. 292 of T. R. 65, 69; Art. 282 of T. R. 74, 77; Hutton *v.* Commissioner, 12 B. T. A. 265, 266. Commissions paid to a banker for selling the taxpayer's corporate stock have not been allowed to be deducted as a current business expense, but have been treated as a capital expenditure. Simmons Co. *v.* Commissioner, 33 F. (2d) 75, 76 (C. C. A. 1st); Appeal of Charles H. Lilly Co., 2 B. T. A. 1058; Appeal of Emerson Electric Manufacturing Co., 3 B. T. A. 932, 935; Harrisburg Hospital, Inc. *v.* Commissioner, 15 B. T. A. 1014, 1017; Frischkorn Real Estate Co. *v.* Commissioner, 21 B. T. A. 965, 969, 970. Compare the requirement that commissions and expenses paid by a lessor in order to secure a tenant be prorated over the term of the lease. Bonwit Teller & Co. *v.* Commissioner, 17 B. T. A. 1019, 1024; Howard *v.* Commissioner, 19 B. T. A. 865, 866; Clawson *v.* Commissioner, 19 B. T. A. 1253; Roby Realty Co. *v.* Commissioner, 19 B. T. A. 696, 698; Butler *v.* Commissioner, 19 B. T. A. 718, 729, 730; Central Bank Block Association *v.* Commissioner, 19 B. T. A. 1183, 1185; Webb *v.* Commissioner, 20 B. T. A. 274; Spinks Realty Co. *v.* Commissioner, 21 B. T. A. 674, 677; Young *v.* Commissioner, 20 B. T. A. 692, 695. Compare also the compulsory proration of fees and commissions paid by a borrower in order to obtain a loan. Lovejoy *v.* Commissioner, 18 B. T. A. 1179, 1182, 1183; S. & L. Building Corp. *v.* Commissioner, 19 B. T. A. 788, 794.

by the taxpayer from the bond issue. They come out of the pocket of the taxpayer only on payment of the bonds at maturity. But, unlike the purchase and sale of property, the transaction contemplated from the beginning a fixed date, the due date of the bonds, at which the difference between the net amount of capital realized upon the issue and the par value of the bonds must be paid to bondholders by the taxpayer. We think that the revenue acts, as they have been interpreted by this Court and the treasury regulations upon this and related subjects, require that this difference between receipts and disbursements of the taxpayer should, in some form, enter into the computation of his taxable income. It is a loss to the taxpayer, definite as to its date and amount, and represents a part of the cost of the borrowed capital during each year of the life of the bond issue. Cf. *United States* v. *Anderson, supra.* At least where the taxpayer's books are kept upon the accrual basis, its final disbursement may be anticipated by amortization and the amortized amount deducted annually from his gross income.

2. Our decision in *Old Colony Railroad Co.* v. *Commissioner, supra,* does not require a different conclusion because the commissions in the present case were allowed before 1913. It was recognized in that case that premiums on a bond issue received after the Sixteenth Amendment might be prorated over the period of the life of the bonds and taxed annually as income during this period. In refusing to allow premiums received before 1913 to be thus prorated and taxed, the Court was moved by the consideration that the premiums, which were received as income and had become a part of the taxpayer's capital before the Sixteenth Amendment, could not be taxed as income by virtue of that amendment and legislation under it.

No such consideration is presented here where the question is only of the deduction of an expense incurred before the amendment. Hence, the decision in the *Old Colony* case can militate against our conclusion here only if returns, prepared in conformity to it, would fail to reflect true income if the rule announced in the *Old Colony* case were also complied with. Plainly such is not the case. There can be no question of receipt of a premium where the bonds are sold at a discount. When sold at a premium, as in any other case, commissions must be deducted

from gross proceeds in arriving at the capital realized upon the bond issue. There is no occasion for deduction of commissions from gross income at a later time unless the total amount realized by the sale of the bonds is less than their par value. In that case the difference alone is the amount to be amortized and deducted from gross income in the annual returns of the taxpayer. This would reflect his true income, where, as in the present case, his accounts are kept on the accrual basis.

Affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.